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Zoetis, Inc. (ZTS)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Third Quarter 2020 Financial Results Conference Call and Webcast for Zoetis. Hosting the call today is Steve Frank, Vice President of Investor Relations for Zoetis.

The presentation materials and additional financial tables are currently posted on the Investor Relations section of zoetis.com. The presentation slides can be managed by you, the viewer, and will not be forwarded automatically. In addition, a replay of this call will be available approximately two hours after the conclusion of this call via dial-in or on the Investor Relations section of zoetis.com.

At this time, all participants have been placed in a listen-only mode and the floor will be opened for your questions following the presentation. [Operator Instructions]

It is now my pleasure to turn the floor over to Steve Frank. Steve, you may begin.

Steven Frank

Head-Investor Relations, Zoetis, Inc.

Thank you, Keith. Good morning, everyone, and welcome to the Zoetis third quarter 2020 earnings call. I am joined today by Kristin Peck, our Chief Executive Officer; and Glenn David, our Chief Financial Officer.

Before we begin, I'll remind you that the slides presented on this call are available on the Investor Relations section of our website and that our remarks today will include forward-looking statements and that actual results could differ materially from those projections. For a list and description of certain factors that could cause results to differ, I refer you to the forward-looking statement in today's press release and our SEC filings including, but not limited to, our Annual Report on Form 10-K and our reports of Form 10-Q.

Our remarks today will also include references to certain financial measures, which were not prepared in accordance with Generally Accepted Accounting Principles, or US GAAP. A reconciliation of these non-GAAP financial measures to the most directly comparable US GAAP measures is included in the financial tables that accompany our earnings press release and in the company's 8-K filing dated today, November 5, 2020. We also cite operational results which exclude the impact of foreign exchange.

With that, I will turn the call over to Kristin.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

Thank you, Steve. Good morning, everyone. Once again, I hope you and your loved ones are safe and healthy as this pandemic continues to be pervasive and unpredictable with COVID cases spiking again in several regions of the US and around the world. We are all facing the uncertainty and fatigue that has come with this pandemic, but I'm also grateful and pleased today to share results that reflect the resilience of the animal health industry, the outstanding performance of our colleagues at Zoetis and the essential value we are providing our customers.

At Zoetis, we've stayed very responsive to the needs of our colleagues and customers throughout the year. We have prioritized our health and safety, while also ensuring that a consistent and reliable supply of products is getting to the clinics, farms and pet owners who need them.

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Our global supply chain and manufacturing operations are running well, with safety and quality as our top priority and we've maintained operations at normal capacity and with no lost output. As we look ahead, we're fortifying our network of suppliers and building inventory levels, while also planning further contingencies for supply and distribution in the months ahead. Our R&D programs also remain on track despite the pandemic challenges, and our field force has been very adaptive to the changing protocols, lockdowns and customer needs in various markets.

Thankfully, our purpose, caring for healthier animals and a healthier world, has never been more important, apparent and appreciated. Thanks to the resilience of our customers and the commitment of our colleagues, we were able to generate better-than-expected results in the third quarter. Our diverse and innovative portfolio has been driving growth this quarter, with companion animal products up 20% operationally and livestock product sales up 9% operationally.

Our newest parasiticide, including Simparica Trio, Revolution Plus, and ProHeart 12 led the way again along with vaccines, key dermatology products and our diagnostics portfolio including reference labs. The third quarter also benefited from sales growth in the US cattle market and China swine market. As a result of the sales growth and targeted investments, we delivered adjusted net income growth of 20% operationally for the third quarter.

Reflecting on our nine-month performance and despite expectations for a more modest fourth quarter, we're increasing our revenue and adjusted net income guidance for the full year. Glenn will provide more details around guidance updates in his remarks. This year has shown once again that Animal Health is a steady and reliable sector, even in times of economic hardship. The world's fundamental need for nutrition, comfort and companionship provided by animals has proven durable and enduring over time.

In the US, veterinary clinic revenues for pets are increasing at double digit rates. Pet owners are focusing again on wellness and chronic illness, not just emergency visits and acute care. While spending more time with their pets, pet owners are much more attuned to their dog's and cat's health, observing conditions like itchiness, dermatitis and pain. While clinic visits are relatively flat in the US, we're actually seeing an increase in average spend per visit. We expect to continue to see our strength coming from companion animal products, especially our parasiticides and key dermatology portfolios across global markets. Simparica Trio's launch and penetration into new clinics in the US and elsewhere is going well, despite the headwinds of COVID-19. And we're seeing a good return to our direct to consumer advertising and digital campaigns for Simparica and Apoquel.

Meanwhile in the livestock sector, producers are adapting to the changes in our end markets for proteins, and their third quarter growth was driven by increased sales in cattle, swine and fish. The spikes in COVID cases, limitations on dining out and shifts in production capacities will continue to make livestock a longer-term recovery story that may vary by region and species, another reason our diverse portfolio and global footprint is such an advantage.

Looking ahead, we have stayed focused on advancing our five key priorities: drive innovative growth, enhance customer experience, lead in digital and data analytics, cultivate a high performing organization, and champion a healthier and more sustainable future. Throughout the year we've stayed on track with our execution and investments in these areas, supported by a strong cash position and clear strategies.

In the third quarter, we achieved an important milestone for our pipeline for pain management in pets. As you know, there's been limited innovation in this area over the last 20 years, and we're excited by the potential of monoclonal antibodies, or mAbs, to be the next breakthrough in long-term pain management. We've been building

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on our research and leadership in monoclonal antibodies for several years and gained valuable experience in the development and launch of our dermatology product, Cytopoint, in 2016. In September, Zoetis received a positive opinion on our latest mAb, Librela, from the Committee for Veterinary Medicinal Products in Europe.

Upon full approval by the European Commission, Librela will be the first injectable monoclonal antibody licensed for alleviation of pain associated with osteoarthritis in dogs. The European Commission approval is anticipated later this year with a potential launch in the first half of 2021. We have additional regulatory submissions for Librela under review by health authorities in the United States, Latin America and Asia Pacific, and we are progressing with similar regulatory reviews for a monoclonal antibody therapy that can help manage osteoarthritis pain in cats, a condition that is vastly underdiagnosed or treated in cats today.

We also continue to bring our leading product into new markets. On the companion animal side, Simparica was recently approved in China and Cytopoint and Revolution Plus gained approvals in additional markets in Asia and Latin America, respectively, and in livestock received approval in Japan for two of our leading swine vaccines, Fostera Gold PCV MH and Fostera Gold PCV, all great examples of how we build and expand our innovation-based franchises.

Last quarter I previewed our latest diagnostic innovation, Vetscan Imagyst, which features a cloud-based artificial intelligence platform. Since then, we have launched it in Australia, Ireland, New Zealand, the UK and the US, and customers have been enthusiastic about its potential to simplify point of care workloads and improve the consistency of results.

And finally, we remain committed to creating a healthier and more sustainable world through our work as a leader in animal health. We've been formalizing our strategy this year and look forward to sharing baseline metrics that are aligned with leading ESG reporting standard before the end of this month.

Now let me hand it off to Glenn, who will speak more about our third quarter results and updated guidance for the full year.

Glenn C. David

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

Thank you, Kristin, and good morning everyone. I hope you and your families are remaining safe and healthy during these difficult times, and I thank you for joining us today.

We delivered another solid quarter with significant growth in both our companion animal and livestock portfolios, and we continue to be encouraged by the strength and resiliency of our business despite the challenging environment due to the pandemic. Today I will provide commentary on our Q3 results, update you on our improved full year 2020 guidance, and discuss our expectations for Q4.

In the third quarter, we generated revenue of $1.8 billion, growing 13% on a reported basis and 15% operational. Adjusted net income of $524 million was an increase of 15% on a reported basis and 20% operationally. Foreign exchange negatively impacted revenue in the quarter by 2% driven primarily by the strengthening of the US dollar. Operational revenue growth was 15% with contributions of 2% from price and 13% from volume. Volume growth of 13% includes 5% from other in-line products, 4% from new products, 3% from key dermatology products and 1% from acquisitions.

Companion animal products led the way in terms of species growth, growing 20% operationally, with livestock growing 9% operationally in the quarter. Performance in companion animal were driven by our parasiticide

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portfolio which includes sales of Simparica Trio in the US, certain European markets, Canada and Australia. We also saw growth in our small animal vaccine portfolio and our key dermatology products, Cytopoint and Apoquel.

The positive momentum for Simparica Trio continued in the third quarter and we expect full year incremental revenue of between $125 million to $150 million. As we've previously mentioned, the COVID-19 pandemic has limited our ability to visit and penetrate clinics at the rate we had originally expected. However, we are finding that once a clinic has converted to Simparica Trio, the adoption level within the clinic is resulting in meaningful incremental market share.

We're also extremely pleased with the performance of our broader parasiticide portfolio which in the US gained an additional 6% market share in the flea, tick and heartworm segment for the third quarter versus the same period in the prior year.

Global sales of our key dermatology portfolio were $251 million in the quarter, growing 16% operationally and contributing 3% to overall revenue growth. Our diagnostics portfolio also contributed to growth due to the continued recovery of wellness visits following a slowdown from social distancing restrictions earlier in the year.

Livestock growth in the quarter was primarily driven by our US cattle business seeing a return to historical distributor buying patterns following the impact of COVID-19 in the second quarter. In addition, the fall cattle run occurred earlier in the year, causing a portion of fourth quarter sales to be pulled forward into the third quarter, and as a result, we expect a significantly weaker fourth quarter in cattle than we typically deliver.

For the remaining livestock species, swine returned to growth in the quarter resulting from expanding herd production in key accounts and increased biosecurity measures in the wake of African Swine Fever in China. We also remain encouraged by the strength of our aquaculture business, which posted the fourth consecutive quarter of double-digit growth. Poultry declined modestly in the quarter which partially offset the growth in cattle, swine and fish.

New products contributed 4% growth in the quarter driven by companion animal parasiticides, Simparica Trio, Revolution Plus and ProHeart 12. Recent acquisitions contributed 1% of growth this quarter, including our expansion into reference labs and the Platinum Performance nutritionals business.

Now let's discuss the revenue growth by segment for the quarter. US revenue grew 18%, with companion animal products growing 21% and livestock sales increasing by 13%. For companion animal, we continue to be encouraged by vet clinic trends with revenue per clinic up 12% in the quarter and demand for our products remaining robust.

Companion animal growth in the quarter was driven by sales of our Simparica franchise as well as key dermatology products. We continue to invest in direct-to-consumer advertising in both therapeutic areas and we have seen a good return on that investment. Simparica Trio continues to perform well in the US with sales of $44 million, despite difficult market conditions for a new product launch.

Key dermatology sales were $180 million for the quarter, growing 17%, with significant growth for Cytopoint and Apoquel, resulting from additional patient share and an expanding addressable market. Diagnostic sales increased 28% in the quarter as a result of our reference lab acquisitions and increased point of care consumable usage.

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US livestock grew 13% in the quarter, driven primarily by cattle. As I mentioned, purchasing patterns returned to historical levels, and we saw earlier movement from pasture to feedlot, both contributing to a significant volume increase for our products. To summarize, US performance was once again strong in what remained a difficult market environment. We remain enthusiastic about the recovery and trends we're observing in companion animal products. While livestock delivered an exceptional third quarter, as we've indicated in the past, we do not expect a sustainable recovery until the middle of 2021.

Revenue on our International segment grew 11% operationally in the quarter with growth across all species with the exception of poultry, which was flat in the quarter. Companion animal revenue grew 20% operationally, and livestock revenue grew 6% operationally. Increased sales in companion animal products resulted from growth in our parasiticide portfolio, vaccines and our key dermatology products. Parasiticide growth in the quarter was driven by the Simparica franchise, including the continued adoption of Simparica Trio, as well as increased promotional activity for Revolution.

In the EU, limited access to veterinary clinics due to COVID-19 restrictions presented challenges for companion animal product sales in the second quarter. But in the third quarter, we saw pent-up demand begin to work its way through the system, particularly for small animal vaccines.

Companion animal diagnostics grew 17% in the quarter, led by an increase in point of care consumable usage. International livestock growth in the quarter was driven by swine, fish and cattle. Swine delivered another strong quarter, with 16% operational revenue growth, primarily driven by China, which grew 159%. While a significant portion of China's growth reflects the impact of African Swine Fever in the prior year, we're continuing to see expansion in our key accounts as production shifts from smaller farms to large scale operations.

Our fish portfolio delivered another strong quarter, growing 10% operationally, driven by an increase in market share in vaccines and the acquisition of Fish Vet Group. Overall, our International segment delivered strong results and was a key contributor to revenue growth with significant growth in companion animal, swine and fish. We were also encouraged to see cattle return to growth in what are still difficult market conditions as a result of the COVID-19 pandemic.

Now moving on to the rest of the P&L. Adjusted gross margin of 69.6% fell 50 basis points on a reported basis compared to the prior year as a result of negative FX, other manufacturing costs and recent acquisitions. This was partially offset by favorable product mix and price increases. Adjusted operating expenses increased 9% operationally, resulting from increased advertising and promotion expense for Simparica Trio and Apoquel. We have strategically reallocated savings, mainly from T&E costs, into these high-return promotional programs which have been successful in increasing sales.

The adjusted effective tax rate for the quarter was 20%, a decrease of 50 basis points, driven by the impact of net discrete tax benefits. Adjusted net income for the quarter grew 20% operationally, primarily driven by revenue growth and adjusted diluted EPS grew 21% operationally. The strength of our balance sheet, along with the significant free cash flow we generate, has enabled us to execute on investment priorities, including direct to consumer advertising, internal R&D and external business development.

While we've suspended our share repurchase program for the last two quarters to preserve cash during the pandemic, we remain committed to our 2020 dividend. In addition, share repurchases are a critical component of our shareholder distribution strategy, and we'll continue to evaluate the appropriate time to resume the program.

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Now moving on to our updated guidance for 2020. We are raising guidance for a second consecutive quarter as a result of our third quarter performance and the improving companion animal market environment. While the COVID-19 pandemic presents challenges and risks, we remain confident in the resiliency and durability of our diverse portfolio.

Please note that our guidance reflects foreign exchange rates as of late October. For revenue, we are raising and narrowing our guidance range with projected revenue now between $6.55 billion and $6.625 billion and operational revenue growth of between 7% and 8% for the full year versus the 3% to 6% in our August guidance.

Adjusted net income is now expected to be in the range of $1.79 billion to $1.825 billion, representing operational growth of 6% to 8% compared to our prior guidance of 1% to 5%. Adjusted diluted EPS is now expected to be in the range of $3.76 to $3.81 and reported diluted EPS to be in the range of $3.38 to $3.45.

We are anticipating a deceleration of revenue growth in the fourth quarter resulting from weaker performance in our livestock business. The impact will filter down to adjusted net income which will also be affected by increased expense as we invest in future revenue growth. In addition, adjusted net income has a difficult comparative period as a result of nonrecurring discrete tax benefits recorded in Q4 2019.

In closing, we delivered another strong quarter, demonstrating the resiliency of our business even in these challenging market conditions. I'd like to once again express how extremely proud we are of our colleagues and the commitment they have demonstrated towards our customers and our company.

Now I'll hand things over to the operator to open the line for your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we will take our first question from Erin Wright with Credit Suisse. Your line is open.

Erin Wilson Wright
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thanks. So I have a couple of questions here. One is on the guidance, the step down in organic growth trajectory in the fourth quarter. I assume that has to do with the underlying pent-up demand you were speaking to, but is there any other dynamics we should be thinking about in the fourth quarter and how that month-to-month trend has progressed here?

And then lastly on mix dynamics in the gross margin, what were some of the key drivers of the gross margin trend in the quarter? Has anything changed in terms of the underlying profit profile of the companion animal business? Just given the strength there, maybe we thought that would be a little bit higher. Thanks.

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

A

Sure. So I'll take both of those questions, Erin. Thank you. In terms – I'll address the mix dynamics first. Nothing has changed really in terms of underlying dynamics. A couple of factors related to the gross margin. A, foreign exchange was particularly unfavorable in this quarter, so that led to a step up a little bit in cost of goods, so that lowered the overall gross margin percentage. Also, we continue to invest in some of the new areas for growth

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such as reference labs and some of the acquisitions which also has a lower gross margin profile than our core business.

But in terms of the underlying dynamics for companion animal and continued growth there being faster than livestock, that will continue to be an overall benefit for gross margin. But the FX as well as some of the investments we're making in newer businesses such as reference labs did have a negative impact.

In terms of the guidance for Q4 and the implied step-down in revenue, a couple of key factor there. A, US cattle being one of the larger ones. We had a very strong quarter in US cattle in Q3 really driven by two factors. A, the acceleration of the fall cattle run bringing some sales from Q4 into Q3 as well as the normalization of buying patterns in Q3 that resulted in some incremental sales that we did not expect to repeat in Q4.

The other thing to consider for US cattle in Q4 is the impact of Draxxin LOE in 2021. We do anticipate that some of our customers may change their buying patterns for Q4, which could result in less sales.

As I mentioned, there are impacts beyond just revenue for Q4. Really, the adjusted effective tax rate is a big driver from an income growth perspective. We had a very favorable tax rate in Q4 of last year that will not repeat this year and will have a negative impact on our overall income growth.

Operator: And we'll move to our next question. It comes from Jon Block with Stifel.

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

Q

Great. Thanks, guys. Good morning. Glenn, maybe just to start with you, and I'll just pick up where you left off on Draxxin. I know you're not going to go down the road of overall 2021 guidance, but obviously we all sort of want to sharpen our pencils, if you would. And so as we think about Draxxin generic next year, should we just be cognizant of call it maybe a $300 million-plus top line item with a year one 20% headwind. If you could comment on that. And then, Kristin, for you. Congrats on moving the pain mAbs forward. Any commentary on the revenue ramp that we might see there and if you feel like you've got a good runway with these offerings in front of any large molecule competition? Thanks, guys.

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

A

Sure, Jon. So, I'll take the Draxxin question. So as you mentioned, Draxxin is a very large product in animal health, over $300 million. A large product for us as well. Because of that, we do expect to see significant generic competition and a number of manufacturers being prepared with a generic product. So we do typically see a 20% to 40% impact over time once a product faces generic competition. Because of the size of Draxxin, we do expect that that will occur over a little more rapid period than we've seen in the past with some smaller products.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. I'll build on the profile for the mAbs. As we talked about, we did get the positive CVMP opinion on Librela. We are expecting an approval later this year with the hope of launching that in the first half of 2021. I know we'll probably get a question why first half. It really depends February, March. It will be around that timeframe. Remember, international has an earlier quarter. So we will see a – start to see a ramp on that product in 2021. We're still expecting approval of the cat pain product, Solensia, in 2021 as well. We'll probably see approval of

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those in the US in the later end of next year. So to give you a sense of just where we see those revenues ramping, both cat and dog in the US and EU.

Operator: And our next question comes from Mike Ryskin with Bank of America.

Michael Ryskin
Analyst, Bank of America

Q

Hey. Thanks, guys. I'll start with a quick one on sort of the rebound from COVID and the recovery in the quarter. I'm just wondering if you parse into it a little, you had a comment in some of your prepared remarks about potentially some pent up demand in Europe. And I'm just trying to get a sense broader across the US as well how much you think the true underlying growth could have been versus what really is a little bit of pent up demand. I realize there's a lot of moving parts in terms of vet reopening and new pet adoptions, things like that. But just curious how to think about that going forward.

And then, Glenn, I've got a quick follow-up for you. Another comment you made on increased spending, reinvesting in the business. As we look out to 4Q, clearly, there's a big SG&A ramp in the guidance if you bridge your revenue gap to your EPS target. I'm just thinking. How should we think about 2021? What's the appropriate base for that, because there's obviously some spend that you pulled back this year? So how much of that comes back? How much extra do you need to invest for things like Librela and Trio next year? I'm just trying to get the moving pieces down. Thanks.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Thanks, Mike. I'll start on the COVID recovery question. I think what you clearly saw in Q3 was a significant rebound in companion animal to people going back to vet visits. But really the big growth driver there wasn't really an increase in vet visits from 2019. It maybe was an increase from Q2 to Q3. It was really an increased spend per visit, which we think is a trend that will continue. As long as people spend more time at home with their pets, they are noticing more and more things are getting diagnosed as well as increased use of diagnostics. Then that is, we believe, definitely a US trend, but we also believe a global trend there. So we think companion animal will continue to do well. I think in the remarks what we had alluded to was that specifically US cattle where we saw real in Q2 a significant dip – people not wanting to hold too many inventories.

In Q3, it was just more of a return to normalizing that. But the other trend was really the move – and it wasn't COVID-related – just weather-related moving of the fall run. So overall from a COVID recovery, I don't think there's any pent-up demand that we're processing anymore. I think things have largely stabilized. Obviously, when you see the number of cases increasing in the US and globally, that's right now baked into the guidance we've given you, assuming that things don't get remarkably worse or remarkably better. But I think all that's sort of baked in. And as we look into next year, I think, it's a little too early for us to really tell exactly what that's going to look at. But I think the key message for us is you look at our performance and our guidance for the year is that we've been incredibly resilient in essential business. And that has really been great for our customers, for our colleagues and for our shareholders.

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

A

Yeah, Mike. In terms of the increased spending in the quarter. So, as you mentioned, we did increase spending in Q3 with total OpEx up about 9% and SG&A up 11%. And really what we did there was we took a lot of the savings that we saw from T&E and made incremental investment behind some of our key growth brands,

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particularly Simparica Trio and Apoquel in the tune of DTC advertising, which was even greater than the savings that we saw from a T&E perspective because we believe those are the right investments, and we're seeing a very strong return on those to support the future growth of the brands.

In terms of what you mentioned for Q4 that the EPS gap between revenue and EPS, the gap there being driven by OpEx, obviously the bigger driver there actually is more related to what I mentioned in terms of the change in the tax rate quarter-over-quarter and the incremental interest expense. It's really not that OpEx is disproportionate to revenue, it's the changes that we're seeing year-over-year just based on some quarterly fluctuations in the tax rate as well as the incremental interest expense that we're going to see in Q4 based on the fundings that we did earlier this year.

Operator: And our next question comes from David Westenberg with Guggenheim Securities.

David Westenberg
Analyst, Guggenheim Securities LLC

Q

Hi. Thanks for taking the questions, and congrats on a good quarter. So on Trio, at least from our research, we're not seeing any competitive entrants yet, and spring is a half year away. VMX is coming up in two months. Is there any – can you help us think about the difference in the Trio peak sales expectation in the event a competitor doesn't launch until after the spring?

And then as a follow up to Trio, you now have had a full season of it. Are you seeing more adoption from heartworm customers or maybe legacy tick and flea prescribers only? And kind of what I'm trying to get at that is essentially there is regional differences in prescribing behavior, and I'm just trying to figure out, again, market size question on Trio. Thank you.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Thanks, David. I'll start with we're not anticipating any combination competition in the US this year or in the first half of next year. As we've talked about many times, we don't have phenomenal intelligence the same way human health does, but we continue to believe that. And to build on what Glenn's comments, as a result, we are investing heavily behind this product in a DTC to gain market share as quickly as we can.

As we look at sort of the growth, Glenn also mentioned in his remarks that the penetration of clinics is improving, but probably not as great as we would have wanted given the difficulty in detailing the product in person. However, where we have penetrated, the sales have been much higher. And honestly, we've been cannibalizing Simparica much less than we expected and we're really seeing is an overall bringing more people in. If you look at flea, tick, heartworm, really only 10% of people who are even taking it are 100% compliant. So we think it remains a significant opportunity for us.

And again, we have a strong franchise here across parasiticides in flea, tick, heartworm, and as Glenn also mentioned, we had a 6% share gain in that overall category, which I think is really impressive. So whether that's Simparica, Simparica Trio, or ProHeart 6 or ProHeart 12, we believe we have the portfolio for our customers no matter where they are in the country, how they practice, or what their pet owners' needs are. So we continue to believe there will be strong growth there and we're going to invest behind this brand next year while we remain the only triple combination in the US.

Operator: And we'll take our next question from Louise Chen with Cantor. Your line is open.

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Louise Chen
Analyst, Cantor Fitzgerald Securities

Q

Hi. Thanks for taking my question here. So I wanted to ask you, broadly speaking, how should we think about 2021 sales and margins? And if you can't give any specifics, could you talk about the likely scenarios that could play out, given a lot of moving parts we see in the year to come? Thank you.

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

A

Yeah, so in terms of 2021, Louise, obviously we'll be providing guidance for 2021 in February, as we typically do. A couple things to think about, right. The long-term fundamentals of the industry remain very strong with increasing pet ownership and also animal protein consumption continuing to grow. I think the other thing to think about for 2021, I think COVID has proven that this industry remains extremely resilient and we're still able to grow very rapidly and operate very profitably even during these times.

Looking into 2021, there's some things that we're very excited about. Obviously the continued growth that we expect to see in Trio, continued growth of our derm portfolio, and obviously the approval of our mAb portfolio and the launch within the EU coming in the first half of the year that Kristin mentioned. Some of the things that may be a headwind obviously are the Draxxin LOE, but again, with the growth that we expect to see in some of the other brands that we've mentioned, we do expect that for 2021 we'll be able to continue to deliver on our long-term value proposition of growing faster than the overall market.

Operator: And our next question comes from Nathan Rich with Goldman Sachs.

Nathan Rich
Analyst, Goldman Sachs & Co. LLC

Q

Good morning. Thanks for the questions. Kristin, maybe to start. Could you comment on the longer-term kind of market opportunity for the monoclonal antibody products in pain? How should we think about the market for osteoarthritis? And then beyond that, is there a potential to expand to additional indications? And then I had a follow up on diagnostics. Could you comment on underlying growth, excluding the reference lab acquisitions? And can you update us on your progress with getting customers to kind of utilize the platform across both the in-clinic and reference lab solutions that you have?

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. So, thanks, Nathan. I'll start on just looking at the overall market for pain, starting with Librela, since it will probably be our first approval there, at least in Europe. Pain right now in dogs is around a $400 million market. But there hasn't been significant innovation in that space. And although we do not yet have a label for our product, we believe as a monoclonal antibody, we'll have a strong efficacy as well as safety profile. And we think that we demonstrated, certainly in derm, our ability to grow the market – to really raise awareness. Bringing innovation in, bring new customers in and new options.

So we do really believe we can continue to do that. If you look at it today, there's about 165 million dogs across the EU and the US, and about 40% of them will get OA. And right now, depending on whether in the US or Europe, really diagnosis is somewhere between 25% and 40%. So we do believe there's a significant opportunity to both grow the market as well as bring people in and better diagnose that to really help that. That's really where we see the market on dogs.

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If you focus on cat, we think there's an even bigger market here, mostly because many cats are not medicalized today. There's 160 million cats. About 40% of them as well have OA. But here you're really seeing, whether you're in the US or the EU, only about 14% of them being diagnosed. And in the US there really is not an alternative. There really is no pain product for cats. There are a few options in Europe. But we really see this as a significant opportunity and ability to grow the medicalization of cats and really to diagnose pain and to treat it.

So we demonstrated, certainly, in dermatology our ability to create and grow markets. And we very much believe across both Librela and Solensia in dogs and cat that we will have the opportunity to do that. We are not expecting competition at this point, certainly, in 2021, from what we understand in this market. So we do believe it's our ability to continue to drive growth and really provide new opportunities for both vets and pet owners to treat pain.

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

And in terms of the diagnostic growth, if you look at companion animal diagnostic growth for the quarter, we grew about 24%. Backing out the impact of reference labs, that growth was around 13%. So we saw very strong growth in our consumable usage. Obviously, our instrument revenue was down, as it's been a little more challenging to get into the clinics to place new instruments. But very strong performance in our overall consumable revenue growth.

In terms of the benefit that we've seen in the usage of both the reference labs and the point of care together, we are very early in our reference labs strategy. We are looking to build out a network across the US, but that will take some time. So we're still early on in that buildout.

Operator: We will take our next question from Chris Schott with JPMorgan.

Ekaterina V. Knyazkova
Analyst, JPMorgan Securities LLC
Q

Hey. This is actually Ekaterina on for Chris. Thank you for taking our questions. And the first question is, you've touched upon this – but how should we be thinking about the durability of some of the COVID-19 tailwinds that we've seen in the US Companion, like rising pet adoptions and increasing standard of care per visit? Do you think that this is something that reverses once people come back into the office and don't spend as much time with their pets? Or is this something that can be more durable as we think about 2021 and beyond?

And then the second question is on the International companion business. So with some of the recent lockdown orders across Europe, what are you seeing on the ground in terms of any initial data points on clinic visits and foot traffic and things like that? How should we be thinking about the trajectory of the International companion business relative to what we saw with the first wave of COVID-19 lockdowns? Thank you.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.
A

Thanks, Ekaterina. What I think we've demonstrated is that overall animal health, and more specifically pet care, is a very resilient industry. And I think what's probably been a little bit different in COVID in a pandemic than certainly an economic challenge is people are adopting more pets. And more importantly, they're spending more time at home with those pets. So in a typical year in the US, you'll see about 3.2 million adoptions. We don't have great data yet on what the increase is, but I think anecdotally no matter where you sit, everyone has a new dog or

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cat in your neighborhood. So we're definitely seeing, as you look at our vaccine sales, certainly an increase in some of these areas.

But I really think what's changing is dogs are becoming a greater part of the family, people are spending more time at home. I don't think that's going to change overnight. And therefore, they're noticing more conditions with their dogs. They're also spending more time at home, seeing our ads and realizing that if they have a dog that's itchy there is a product for that. So I don't think that trend – maybe it was more accelerated this year, but I think dogs and cats are here to stay. I think people will change their behaviors, some of them, I think, around spending more time with the comforts, both emotional and otherwise, of pets will continue.

And as you look at Europe, your question with regard to COVID in Europe, the data in Europe as you know is not as reliable as in the US. There's not as many comprehensive data sources. But what we're hearing anecdotally is our customers figured out in Q2 how to continue to see pets through curbside check-ins, and that really hasn't changed. They've figured out how to operate given they're an essential business, and we really don't – we have not seen so far any significant changes.

Obviously, there's incremental lockdowns being announced, and obviously in the last 24 to 48 hours in Italy and other places. But as you look at our guidance for the year, unless it gets significantly worse we think that's baked in. And I think as you look at what we've learned between Q2 and Q3, we think that our customers will be able to manage well as they move into 2021, certainly in the pet care side, to manage continuing to see pets and to diagnose them, either through telemedicine or through curb-side check-ins. So we do believe the trends there are resilient.

Operator: Our next question comes from John Kreger with William Blair.

Jonathan Kaufman
Analyst, William Blair & Co. LLC

Q

Hi. Good morning. This is Jon Kaufman on for Kreger. First, I would like to go back to diagnostics. I know your reps aren't able to visit the clinics as much as usual. But can you talk about the initial reaction to the Imagyst product? When your field teams are discussing this with clients, understanding that right now some of these use fecal samples, how are they describing the potential for broadening out the potential use? I guess, is there an expectation that there's going to be a consistent introduction of new application?

And then I would also just like to ask about poultry. Can you just provide more details around what's going on there? It's typically one of your faster growing areas in livestock. So just trying to get a sense of what changed this quarter. Is it part of a typical rotation of product usage? Or is it some sort of competitive dynamics there? Thank you.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. I'll start on the diagnostics, on Imagyst. We are very pleased with how that's going. As you know, the first indication for the Imagyst, which is an AI-driven diagnostic, is in fecal. That's about a $500 million market, growing about 7%. People are excited at the opportunity for this technology, and certainly for additional indications, so we are on track there. And I think we've very pleased with its progress. And given the positive receptivity to it, we are accelerating our investments to bring new indications overall there.

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And as you look at poultry, certainly in the US there is definitely a rotation which we always talked about and that was definitely a driver in the quarter, and I think you'll see again moving into Q4. It's also potentially one of the reasons we guided where we did on livestock overall in Q4. Obviously, there's the overall impact to all of the livestock sectors of COVID and less consumption and more dine-in versus dine-out. But poultry specifically, it was more around the rotation there.

Operator: And our next question comes from Balaji Prasad with Barclays.

Balaji Prasad
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. And thanks for taking the questions. So I want to get to China and discuss both the companion animal side and the livestock side of the business. So you had a 63% growth in China. And I thought I heard you say that you had 140% growth in livestock. So could you, A, quantify any kind of swine reherding happening in China, and how the effects you're seeing in the business and if the 140% number is correct?

And secondly, on companion animal, could you speak about your expectations on Simparica? And also give us a sense of the time lag before you introduce Trio? And what are the gating factors to introduce that? Is it more regulatory or your own life-cycle planning? Thanks.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. I'll start in, and I'll let Glenn build on this. We were very pleased obviously with the growth in China, and really the balance between companion animal and livestock there. Certainly, on the livestock side, we are seeing a faster than we expected growth coming back from ASF, but really with the large integrated producers. There's still a significant ASF challenge there, but given the biosecurity of some of them, we are seeing significant growth there. And in companion animal, similar to some trends in other places, just great growth across the portfolio and strong performance there.

Certainly, on REVOLUTION, launching RIMADYL, just now getting the approval on Simparica, it's more a timing of regulatory on Trio there. But I'll let Glenn get into some of the specifics on the numbers and the growth.

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

A

Yeah, so just to get into the details on number. As you mentioned, overall, China for the quarter grew 63%. We saw 52% growth in companion animal, and we saw 81% growth in livestock and that 81% growth in livestock was driven by swine. So as Imentioned in the prepared remarks, swine grew 159% in China for the quarter as we've continued to see the recovery in some of our key accounts and the larger producers, we've seen very strong performance of our products within those accounts.

Operator: And our next question comes from Navin Jacob with UBS. And we will actually move on to Kathy Miner with Cowen and Company.

Kathleen Miner
Analyst, Cowen and Company

Q

Thank you. Good morning. Just two questions, please. First, I'd just like to go back to the canine market where you sized it up at about $400 million. Can you give us a sense of how much of that might be outside of the United

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States? And does the treatment of canine OA pain differ from the US such that a launch or uptake may be different?

And second question on Apoquel and Cytopoint, it looks like trends for those products continue to be very strong. So as you go forward, is this strength more sustainable than you may have initially thought pre-COVID just because there's more pets that have been adopted, and owners are at home more, so perhaps you see more use of these products? Thank you.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. So speaking of – first of all, Kathy, great to hear from you. As we look at the pain market for dogs, that's $400 million. If you look at the number of dogs, the EU has 90 million dogs and the US has 75 million. And as you look at the 40% prevalence of OA is the same across. But in the US, really it's only diagnosed about 28% versus 50% in the EU.

The only thing we've learned with new technologies is that given we can do direct-to-consumer advertising in the US, we tend to be able to ramp faster to peak sales when we're launching new technologies in the US than we are able to do in Europe, just given we can't do direct-to-consumer advertising that's brand specific. So I do think we look at how fast can you ramp up that market in Europe. It will be slower than the US once we have a US just given the history. And ultimately, I think we'll do well there but I think it is a little slower I would say overall there.

And your second question was around, what was it?

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

A

Around derm.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Okay.

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

A

So in terms of the opportunity for derm, so we continue to see really strong performance in the derm portfolio. We grew 16% this quarter with 21% growth year-to-date. In terms of the continued opportunity for growth, we see opportunity for growth in both the US and International. So looking at the US, currently there are about 75 million dogs in the US and about 14 million dogs have itchiness. Of those 14 million dogs, today about 60% are treated. So there's still 40% of the dogs with itchiness that are not treated. So we do think there is an opportunity to continue to raise awareness of the disease state and get those itchy dogs continue to take Apoquel or Cytopoint.

When you look outside of the US, we also see a big opportunity for growth. In terms of the breakout of our sales today, about two-thirds of our sales is US and one-third is International. However, the number of itchy dogs is similar between those segments. So to the extent that we're able to continue to drive that adoption and awareness, we do believe that there's continued growth expected in the International markets as well.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

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And the other thing I'll say, we're still looking at not having competition so – at the earliest, the second half of next year, so we're going to obviously continue to try to grow this as fast as we can and gain market share.

Operator: And our next question comes from Navin Jacob with UBS.

Sriker Nadipuram
Analyst, UBS Securities LLC

Q

Hi, everyone. It's Sriker Nadipuram on for Navin Jacob. Apologies for getting cut off before. But I just have a couple of questions. So in anticipation for the Draxxin generic coming next year, what level of destocking can we expect to see? And then maybe just on the medicalization rate in osteoarthritis, what's a good analog for how high you think it can get in dogs and cats in the US? Thanks very much.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Starting on Draxxin, I mean, it's a little bit hard to tell you exactly what we think the destocking will be. I think, given the expectation for many of our customers that they will see significant new generic entrants, I'm sure they will think differently about building inventories ahead of normally what is our price increases in Q1. And that was sort of what Glenn was alluding to earlier.

Obviously, we have a robust defense plan for Draxxin. It's an important product. We still have – given its high margin significant pricing leverage here, but obviously, we anticipate that some of our customers who would normally stock up at the end of the year ahead of a price increase will not be doing so there.

And how high can medicalization rates get for OA? I mean, you'd love to believe that all those dogs would be diagnosed. I don't think you're really going to really ever get to that exact number. But we try to look at our ability, for example, in derm, to try to do that. So we do think there's a significant opportunity, both because we're bringing innovation, and we also believe that the anticipated potential safety profile of a mAb will bring more people out that are struggling, certainly on the dog side but definitely on the cat side as well.

So, I think it's a little too early to say exactly where you can go. But there's a significant opportunity, and we've demonstrated before that we've been able to grow markets as we've entered them with new innovative technologies.

Operator: Our next question comes from Elliot Wilbur with Raymond James.

Q

Hi, guys. This is actually [ph] Michael Paralari (51:48) on for Elliot Wilbur. Thanks for taking my question. Most of my questions have actually been answered already, so I just have one for you on the topic of share repurchases. I know that you said that you're continuing to evaluate the resumption of the program. But given the strong recovery in the business, I was just wondering if you guys had any timelines specifically on when you were looking to resume the program, and if you were looking for anything specifically on deciding whether or not to resume the program. Thank you.

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

A

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Yeah, thanks, Michael. So in term of share repurchase, we don't have any specific timeline. Obviously, it's something that we'll continue to evaluate. There's still a lot of uncertainty in the marketplace particularly around COVID-19 and the timing that we expect to see a full recovery. So that's one of the factors that we'll continue to evaluate.

One thing I'll say is that our capital allocation priorities have not changed right in terms of investing in the business as our first priority. And I think you see us doing a lot of that this year, even in light of COVID, particularly with the investments that we're making in DTC, the investments that we're making in R&D to continue to support the medium, short, and long-term growth of this company.

Also significant investments that we're making in manufacturing to ensure continuity of supply – and also investments that we're making from an inventory perspective, again, to ensure continuity of supply. So we are really focusing on some of those internal investments. We've also been able to execute on some business development deals throughout this year as well, even with the limitations that may be provided by COVID. But really good use of our capital across all areas.

Operator: [Operator Instructions] . Our next question is a follow up from Balaji Prasad with Barclays.

Balaji Prasad
Analyst, Barclays Capital, Inc.

Q

Hi. Thanks for taking the question again. So I was just trying to check on your comment on the market share in the flea and tick and heartworm segment. A 6% gain. I just wanted to clarify if that was based on a market size of $2.5 billion, $2.6 billion. Could you clarify that? Thanks. And secondly, also what was the actual number for Trio this quarter?

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

A

Yeah. So just to clarify, that was based on the US market size of around $2.5 billion. And second question was around Apoquel for the quarter – for Trio. I'm sorry. So the Trio for the quarter we did $50 million in sales for Trio for the quarter.

Operator: And at this time, there are no additional questions. I'd like to turn the program back over to Kristin Peck for any closing remarks.

Kristin C. Peck
Chief Executive Officer & Director, Zoetis, Inc.

Okay. Well, thank you all for your questions and continued interest in Zoetis. We look forward to keeping you updated on our business and continuing to deliver the results and innovations that you and our customers expect from us. Stay well. Thanks so much.

Operator: Thank you for your participation. That does conclude today's program. You may disconnect at any time.

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