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Zoetis, Inc. (ZTS)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Fourth Quarter and Full Year 2022 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 open for your questions following the presentation. [Operator Instructions] In the interest of time, we ask that you limit yourself to one question and then queue up again with any follow-ups. Your line will be muted when you complete your question. [Operator Instructions]

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

Steven Frank

Vice President-Investor Relations, Zoetis, Inc.

Thank you, operator. Good morning, everyone. And welcome to the Zoetis fourth quarter and full year 2022 earnings call. I am joined today by Kristin Peck, our Chief Executive Officer; and Wettey Joseph, 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 statements in today's press release and our SEC filings, including but not limited to, our Annual Report on Form 10-K and our reports on 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 the company's 8-K filing dated today, Tuesday, February 14, 2023. 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, and welcome everyone to our fourth quarter and full year 2022 earnings call. Today, we reported strong full year results for 2022, in line with the high-end of our guidance from November, and thanks to our diverse portfolio, global scale and talented colleagues.

Our 8% operational revenue growth for the year was driven by our innovative companion animal portfolio, which grew 14% operationally, while our livestock portfolio declined 2% operationally primarily due to generic competition and market challenges especially in the US. Thanks to our broad global scale and diversity, we delivered well-balanced operational growth across our US and International segments, which grew 7% and 9% respectively.

For the year, we generated operational growth in all of our top 13 markets despite the economic challenges, continued COVID-19 recovery and political uncertainty created by the war in Ukraine. Reflecting our long-standing value proposition, we grew our adjusted net income faster than sales for the year with an operational increase of 11% for the full year, and we use this performance and financial strength to continue investing in the R&D, manufacturing capacity, and sales and marketing resources to support our future growth and pipeline.

As we begin 2023, we will stay adaptable to the evolving macroeconomic factors and geopolitical tensions around the world and focus on executing our plans. We remain very confident in the fundamental and resilient global demand for animal care. And most importantly, we are confident in Zoetis' ability to continue delivering solid sustainable growth as we resolve our prior supply constraints and build share of our market-leading franchises.

Looking ahead, we are committed to our track record of value creation and above-market performance even in the face of today's economic uncertainty. We are well-positioned with our strategic priorities and capabilities to expand in large and growing product areas like parasiticides, dermatology products, monoclonal antibodies, vaccines and diagnostics.

We are guiding to a range of 6% to 8% operational growth for revenue in 2023 and adjusted net income growth in the range of 7% to 9% operationally, which reflects our increased investment plans for R&D and manufacturing to

support growth. As the world leader in animal health, a market that has grown on average of 5% to 6% through various economic cycles over the last two decades, we feel very positive about how our portfolio, pipeline and strategy can drive long-term sustainable growth and create value for our customers and shareholders.

Wetteny will discuss more details about the 4Q results and full year 2023 guidance, but let me provide some additional perspective on our business and set the stage for some of our growth drivers for the year.

First, we have remained the world leader in animal health over the last decade, outperforming the market and bringing groundbreaking innovations to veterinarians, producers, and pet owners who care for animals.

We marked our 10-year anniversary as a public company on February 1, a decade which saw us bring more than 2,000 new products and lifecycle innovations to market, build a diverse portfolio featuring market-leading franchises and 15 current blockbusters, generate consistent above-market revenue growth and deliver total shareholder return of more than 500%, all while increasing our market cap from \$16 billion in 2013 to about \$75 billion today.

While we celebrate those accomplishments, I'm even more excited about where we can go in the next decade and by the talented colleagues, innovative pipeline, and best-in-class capabilities we have brought together at Zoetis. Our colleagues' purpose-driven mindset and steady performance in the face of adversity give me confidence in the continued execution, innovation, growth and durability of our business.

As we turn to 2023, we're focused on five key growth catalysts for the year. In dermatology, we see excellent growth opportunities even after nearly a decade of game-changing innovation that began with the introduction of Apoquel in 2014 and has continued with the success of our first monoclonal antibody, Cytopoint, as well as recent lifecycle innovations like Apoquel chewable. We continue to see even more opportunity to grow and expand in this market.

In pet parasiticides, the largest single product area in animal health, we continue to gain share and are now the second largest in revenue for this category. We've improved supply in 2023. We expect to continue expanding share in this market and supporting our diverse mobile portfolio featuring Simparica Trio, our triple combination product.

In the area of pain, we are off to a great start with our two monoclonal antibodies for osteoarthritis pain, Librela for dogs, which became our latest blockbuster in 2022, and Solensia for cats. We are once again revolutionizing care in this category and seeing very positive early reaction to both products in [ph] their launch (00:07:54) markets as we continue to expand geographies and supply.

In terms of the US approval for Librela, we remain confident in receiving approval in the first half of 2023 [ph] with a launch planned (00:08:04) for late in the year.

In diagnostics, we continue to generate solid above-market growth in the International market, above our go-to-market model in the US, and drive greater global adoption for Vetscan Imagyst, our AI-based diagnostics platform.

And finally, as population growth and economic mobility drive more demand for animal protein and pets, we see major opportunities in fast-growing emerging markets outside the US where our portfolio is well-suited to meet those evolving needs.

Overall, our business continues to be weighted towards higher growth, innovation-driven areas in companion animal, and these will remain our growth drivers for the foreseeable future. Meanwhile, our livestock portfolio will remain a valuable cash generating piece of our business as we continue to recover in the US from generic competition and show solid growth in emerging markets.

As always, we will stay disciplined yet adaptable in our approach to the new market opportunities, potential challenges and economic shifts that could occur. And in conclusion, Zoetis remains well-positioned in terms of our market leadership, financial strength, investment strategy and diverse portfolio to deliver sustainable growth in 2023.

Thank you, and I'll hand this off to Wetteny.

Wetteny Joseph

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

Thank you, Kristin, and good morning, everyone. As Kristin mentioned, we had a strong year in 2022 with revenue of \$8.1 billion and adjusted net income of \$2.3 billion, both in line with the high-end of our November full year guidance range. Full year revenue grew 4% on a reported basis and 8% operationally, with adjusted net income increasing 3% on a reported basis and 11% operationally.

Looking deeper into the operational growth for the year, price contributed 3% to full year operational revenue growth, with volume contributing 5%. Volume growth consisted of 4% from new products, including Simparica Trio and our monoclonal antibodies, Librela and Solensia, and 2% from key dermatology products, partially offset by a decline of 1% from other in-line products.

Revenue growth was broad-based with positive operational growth in each of our top 13 markets, which make up approximately 85% of our total revenues, with International growing 9% operationally and the US growing 7%.

Our growth was driven by continued demand for our innovative products in our companion animal portfolio, which grew 14% operationally. Our companion animal portfolio now makes up 64% of our global revenues. This growth was partially offset by our livestock business, which declined 2% operationally, primarily due to the generic competition, supply constraints as well as challenging market conditions in certain geographies.

Performance in companion animal was driven by our small animal parasiticide portfolio which grew 20% on an operational basis. Simparica Trio generated \$744 million in sales, growing 58% on an operational basis. Our Simparica franchise reached \$1 billion in global revenue for the first time in 2022.

Our key dermatology products generated \$1.3 billion in sales, posting strong growth of 17% operationally, with double-digit growth in both International and the US. Key dermatology growth in our International markets was especially strong at 27% operationally. We continue to see solid growth in our monoclonal antibodies for osteoarthritis pain.

As expected, sales of Librela eclipsed the \$100 million mark on the year, marking Zoetis' 15th blockbuster product. We look forward to Librela's expected launch in the US in late-2023. Solensia contributed \$30 million in sales in 2022, primarily from International markets with solid [ph] plan (00:11:56) penetration in the US after a launch late in the year.

Our companion animal diagnostics portfolio declined 2% operationally in the year, with declines in US partially offset by growth internationally. Our livestock business declined 2% on an operational basis. Our portfolio continues to be challenged by generics and cheaper alternatives for Draxxin in cattle as well as Zoamix in poultry.

We do expect these generic impacts to begin to moderate in 2023. Additional declines were driven by supply challenges on certain livestock products as well as unfavorable market conditions, especially the US cattle and China swine markets.

Moving onto our Q4 financial results, which was another strong quarter. We closed Q4 with revenue of \$2 billion, representing an increase of 4% on a reported basis and 9% on an operational basis. Adjusted net income of \$539 million is an increase of 14% on a reported basis and 27% operationally. Of the 9% operational revenue growth, 3% is from price and 6% from volume. Volume growth consisted of 3% from new products, which includes Simparica Trio as well as Librela and Solensia, and 2% from key dermatology products, while other in-line products grew 1%.

Companion animal products grew 15% operationally, while our livestock portfolio was flat in the quarter. Simparica Trio was the largest contributor to growth in the quarter posting global revenue of \$171 million, representing operational growth of 39% for the quarter. We expect Simparica Trio to continue to grow the addressable market for flea, tick and heartworm globally, and drive the conversion from collar and topical parasiticides to oral combination products. These dynamics will provide additional run rate for future extension of the broader market and revenue growth for Trio, even when competing triple combination products enter the market.

Our key dermatology products, Apoquel and Cytopoint, had solid global growth in the quarter, posting \$347 million of revenue, representing 14% operational growth against a robust prior year in which key dermatology grew 23% operationally in the fourth quarter of 2021.

Our monoclonal antibodies for osteoarthritis pain in dogs and cats continued to grow, posting \$39 million of revenue in the quarter, primarily in International markets. Meanwhile, sales of livestock products were flat on an operational basis in the quarter, with growth in fish and poultry offset by the impact of generics and supply constraints on cattle and swine products.

Now moving on to revenue growth by segment for the quarter. US revenue was \$1.1 billion in the quarter, growing 7%, with companion animal sales growing 12% and livestock sales declining by 6%.

Focusing first on companion animal, we returned to double-digit growth in the quarter as we resolved the majority of our supply issues from earlier in the year. In the US, veterinary practice revenue is growing approximately 6% and spending per visit remained strong again this quarter, increasing 10% despite a 4% decline in clinic visits in the quarter.

The visit decline reflects comparison to the peak visit numbers in 2021, driven by pandemic aftereffects and increased adoption of pets as well as the impact of veterinary workforce challenges that have limited some clinic capacities. Absolute clinic visits remain above pre-pandemic levels. We continue to see growth in the retail segment outpacing other channels. In Q4, sales to our retail partners grew by 49%.

Simparica Trio continues to drive growth in the quarter with sales of \$158 million in the US, growing 39%. With the supply constraints from earlier in the year largely resolved, we were able to leverage promotional efforts to drive growth and regain market share in the quarter.

Key dermatology product sales in the US were \$239 million for the quarter, growing 11%, with Apoquel and Cytopoint each growing double-digits. We expect to continue expansion of the market for the foreseeable future.

US livestock declined 6% in the quarter, as expected, with sales of cattle products impacted by supply restocking for certain products in the third quarter of 2022 as well as the impact of generic competition in cattle and poultry.

Moving on to our International segment where revenue was flat on a reported basis and grew 12% operationally in the quarter. International companion animal revenue grew 21% operationally and livestock grew 4% operationally. Increased sales of companion animal products resulted from growth in our parasiticide portfolio, our key dermatology products, and our monoclonal antibodies for alleviation of osteoarthritis pain.

Our International small animal parasiticide portfolio had a very strong quarter. Growth was driven by our Revolution franchise, which rebounded well from supply challenges, especially in China. Our key dermatology products contributed \$108 million of revenue and grew 22% on an operational basis in the quarter, with growth in Cytoint across all key markets and continued double-digit growth of Apoquel.

We continue to be pleased with the performance of our OA pain portfolio with Librela generating \$26 million and Solensia delivering \$7 million in fourth quarter sales internationally. Librela sales in the quarter dipped slightly below the prior quarter due to the removal of supply allocation in certain markets, which led to higher inventory levels at the end of Q3. We expect to see significant contribution to growth in 2023 coming from Librela across our International segment.

Moving on to our International livestock segment which grew 4% operationally in the quarter. Our fish portfolio grew 25% operationally due to increased demand for vaccines in key salmon markets including Norway and Chile. Sales of poultry products grew due to increased demand for poultry protein. Growth was partially offset by swine sales, which declined due to supply constraints in certain vaccines across International. The swine decline was partially offset by growth in China, driven by a weak comparative quarter in the prior year and improved swine market conditions.

Now moving on to the rest of the P&L for the quarter. Adjusted gross margins of 68.1% decreased 150 basis points on a reported basis compared to the prior year, resulting primarily from unfavorable foreign exchange impacts. Operationally, gross margin declined 60 basis points, driven by higher inventory charges as well as higher manufacturing and freight costs, which were partially offset by favorable price and mix.

Operationally, adjusted operating expenses decreased 6% with SG&A declining 9%, driven by lower compensation-related expenses and lower advertising and promotion, partially offset by higher freight and logistics-related expenses. R&D expenses increased 10% operationally due to higher compensation costs and higher project spend. The adjusted effective tax rate for the quarter was 20.8%, an increase of 220 basis points, primarily due to lower net discrete tax benefits in the quarter and a lower benefit in the US related to foreign-derived intangible income.

Adjusted net income grew 27% operationally and adjusted diluted EPS grew 30% operationally for the quarter. Capital expenditures in the fourth quarter were \$171 million. In the quarter, we repurchased approximately \$400 million of Zoetis shares and returned over \$0.5 billion to shareholders through a combination of share repurchases and dividends. For the year, we have repurchased almost \$1.6 billion of Zoetis shares and returned over \$2.2 billion to shareholders. In December, we announced a 15% annual dividend increase, continuing our commitment to grow our dividend at or faster than the growth in adjusted net income.

Now, moving on to our guidance for the full year of 2023. Please note that guidance reflects foreign exchange rates as of late-January. We are expecting foreign exchange to have a minimal impact versus the prior year, with the full year impact neutral at revenue and slightly accretive at adjusted net income.

The foreign exchange impact in the first half will be unfavorable versus prior year, particularly in the first quarter. In the second half of the year, foreign exchange is expected to be favorable based on the late-January exchange rate.

For 2023, we are projecting revenue between \$8.575 billion and \$8.725 billion, representing a range of 6% to 8% operational growth. Volume will be 1% to 2% at the low-end our guidance range and 3% to 4% at the high-end. We again expect companion animal to be the primary growth driver in 2023 with the continued strength of our diverse parasiticide portfolio, the adoption of our monoclonal antibodies for OA pain and further expansion of our key dermatology products.

Despite the decline in vet clinic visits last year, industry fundamentals remain strong. Visits remain above pre-COVID levels and clinic revenue is at an all-time high as the standard of care continues to increase.

We anticipate modest livestock declines in 2023 driven by the generic impact on Draxxin sales, particularly in the first half, as well as unfavorable market conditions in US cattle. These declines will be partially offset by growth in poultry driven by increased demand for poultry protein and new product launches as well as fish. The fundamental trends which make livestock an essential business remain intact.

I'd like to touch upon the key assumptions that underpin our expectations for revenue growth. For companion animal, we assume a triple combination product will launch in the US in the first half of 2023 to compete against Simparica Trio. We expect this entrant will help Trio drive the conversion from topicals and collars to triple combination oral parasiticide and still project significant growth for Trio.

We do not expect competitive entrants in 2023 for our key dermatology products, Apoquel and Cytopoint. We expect another year of robust growth of our key dermatology portfolio coming from continued expansion of the dermatology market and price. We are excited about the continued growth in our OA franchise and plan to launch in several new markets next year.

For the remainder of the P&L, adjusted cost of sales as a percentage of revenue is expected to be in the range of 29.5% to 30% where favorable foreign exchange price increases and product mix are partially offset by higher input costs.

Adjusted SG&A expenses for the year are expected to be between \$2.06 billion and \$2.1 billion, with the increase from 2022 focused on supporting primary drivers of revenue growth. Adjusted R&D expenses for 2023 is expected to be between \$635 million and \$660 million. R&D spend can fluctuate year-over-year. This increased investment is reflective of both new projects as well as those advancing in our pipeline.

Zoetis is the leader in animal health because of the disruptive innovation, novel products and lifecycle enhancements we bring to the market. This increase in R&D expenses reflects our commitment to ensuring our capital allocation prioritizes innovation.

Adjusted interest and other income/deductions are expected to be approximately \$170 million. Our adjusted effective tax rate for 2023 is expected to be in the range of 20% to 21%. Adjusted net income is expected to be in the range of \$2.49 billion to \$2.54 billion, representing operational growth of 7% to 9%.

Our guidance once again reflects our value proposition of growing revenue in line with or faster than the market and growing adjusted net income faster than revenue. We expect adjusted diluted EPS to be in the range of \$5.34 to \$5.44 and reported diluted EPS to be in the range of \$5.03 to \$5.14.

We are anticipating capital expenditures in 2023 to increase to \$950 million to \$1 billion. We continue to make investments to support our future growth, including manufacturing capacity for our monoclonal antibodies as well as oral solid dosage.

Finally, while Zoetis and the animal health industry remain resilient in the face of economic headwinds, our 2023 guidance range is reflective of uncertain macroeconomic conditions and the impact of veterinary clinic labor challenges.

While guidance represents our expectations for the full year, Q1 revenue is expected to be below the low-end of the operational growth rate in our full year guidance due to a variety of reasons. First, Q1 2022 was a strong comparable quarter as we saw a robust growth with limited impact from vet clinic labor constraints, as well as minimal disruption from our diagnostics field force model change which began in Q2.

Additionally in the quarter, we expect to see lingering impacts of the latest COVID wave in China. Lastly, the return of supply on certain products, including Simparica Trio, and subsequent channel restocking as well as promotions to regain share in Q4 2022 modestly increase inventory levels in the channel in the short term. In Q1, we expect a modest decline in adjusted net income versus the prior year and the result of the timing of our 2022 field force expansion in the US, which did not start until Q2, as well as the R&D investment noted earlier which is also off a low base in Q1 2022.

Now to summarize. 2022 was another strong year. Despite some challenges, we significantly outperformed the market and continued to take share, all while growing the bottom line faster than the top line. As we began 2023, we once again expect to grow faster than the market, driven by the strength of our innovative portfolio, our ability to successfully launch new products and expand existing markets and our confidence in the end market dynamics for the spaces we compete in.

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

QUESTION AND ANSWER SECTION

Operator: At this time, we will open the floor for questions. [Operator Instructions] We'll take our first question from Michael Ryskin from Bank of America.

Michael Ryskin

Analyst, BofA Securities, Inc.

Q

Great. Thanks for taking the question and congrats on the quarter, guys. I'm going to throw in a couple just real quick. First, would love to get your latest thoughts on NexGard Plus, the BI triple combo, now that it's been unveiled at VMX, just what are your expectations for Simparica Trio growth this year, if you could give us a ballpark for that?

And then, second, I want to talk about R&D spend in 2023. It seems to have jumped quite a lot year-over-year, and that's a big part of why operating margins aren't expanding as much as we're used to. Any specific programs you want to highlight and anything you can say in terms of when that R&D spend will translate into future launches? Is this something that's sort of in the regulatory phase or late clinical phase? Just give us a sense of where the extra \$100 million year-over-year is going. Thanks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Thanks, Mike. I'll take those and let's see if Wetteny has anything to add. But first, on Trio, obviously, we had a phenomenal year with 58% growth; really proud of that. Obviously, we got back in clinics after some of the supply problems, and we're fully back there. We've got 90% penetration, with an 80% reorder rate and are now the number 2 flea, tick, heartworm there. We are expecting competition from NexGard Plus sometime in the first half, we [ph] as I'm sure you know (00:28:50) don't know exactly when that will be.

But we continue to expect the market to expand, and we continue to expect Simparica Trio to be growing on the year, albeit probably not at 58%, but we expect it to have a very strong year. I think what you're going to see is really moving more customers from collars and topicals into what is a best-in-class flea, tick, heartworm combined oral product. So we expect to continue to go through this as we've continued to say. We don't have any more information on the exact timing there, but we're going to be aggressive as you've seen us in Q4 and Q1 really investing behind this brand, doing DTC, et cetera. So we expect strong growth there continuing even with a new entrant.

And when you think about R&D spend, and I'll start and let's see if Wetteny wants to build there, we've gotten questions often from you and from a lot of our investors, why don't you spend more in R&D or if you had a program would you invest in it? And I think what we're demonstrating is, we see a very strong pipeline here. These incremental investments, to your question, are certainly the bigger ones are in late-stage development going into development, [ph] the cost of that (00:29:52), but also some great new technologies in the research side as well. So it's broad across the portfolio. It is a significant investment. And hopefully, it's a sign to all of you of our confidence in our pipeline and the strength of our R&D engine and our willingness to invest in that for the short and the long-term across there.

We see, obviously, really big platforms there in parasiticides, continuing to invest there, in dermatology, and across our monoclonal antibody franchise. Certainly, looking at long-acting, as we've talked about, but also new disease areas.

So I don't know if I missed anything, Wetteny. Do you want to add anything?

Wetteny Joseph

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

A

No, look, I would just add a couple points going back to Trio. We expect, as Kristin said, for Trio to grow significantly in the year although as we now are well into our third year with the product, and we wouldn't expect it to continue to grow at 58%, which is what it did in 2022. Now, the timing of our supply recovery in 2022 and the fact that as we see competition come in, it may drive some promotional activity that might drive some variability in terms of quarter to quarter in terms of where the growth is. But, for the total year, we expect significant growth on Trio.

I think then on the R&D spend, it's our practice that we don't actually dictate what the investment in R&D is going to be. We let the pipeline dictate it. And so, as we see our programs either coming into research or coming out of research into development or into late development, as those programs require spending and we do a full ROI spec, et cetera, on them, we go ahead and fund those. And so very pleased to see that the pipeline is demanding this level of investment, and we'll still be able to deliver faster growth at ANI than revenue based on our guide of 6% to 8% at revenue and 7% to 9% at adjusted net income.

Operator: Our next question comes from Jon Block from Stifel.

Jonathan D. Block

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great. Thanks, guys, and good morning. Wetteny, the 4Q GM of 68.1% was a little bit below us for the quarter, but the 2023 guide at 70% to 70.5% was certainly solid. So maybe if you can just talk to the drivers for 2023 gross margin [ph] are those – is (00:32:03) the supply chain easing, maybe a little bit about the cadence.

And then maybe just sort of as a tack-on to that or the second question, in 2022, it was sort of a tale of two halves for atopic dermatitis. 1H was operational around 20%; 2H operational, I think, was closer to 10%. I think you guys alluded to solid growth in 2023. But do you want to just frame that for us? Is it a continued deceleration of atopic dermatitis into 2023 with no competition, because I think you clarified that? Or can we expect some level of stabilization, call it, in that high-single, low-double-digit range for the atopic dermatitis franchise? Thanks, guys.

Wetteny Joseph

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

A

Yeah. So I'll start and see if Kristin would add anything here. Let's start with gross margins. Look, if you look at the year, we were able to expand margins on the year. And certainly, as we explained in the prepared commentary, we saw FX come in to the tune of about 80 basis points of headwind against gross margin in the fourth quarter. And certainly, we've seen input costs as well as some manufacturing costs impact the gross margin picture that you saw in the fourth quarter. But, given where OpEx came in, you saw substantial growth at ANI versus revenue where revenue came in at 9% on the quarter, ANI coming in 27% growth on the quarter.

I think, as we go into 2023, given the timing of our price increases which start at the beginning of the year, as you know, certainly, we've seen some inflation and input costs coming out of 2022. But we go into 2023 with price increases that start to change that as we go into 2023, which is why we give guidance where we see about 40-basis point gross margin expansion on the year. And obviously, 1 point, if you look at the midpoint of our guidance on growth, higher at ANI versus the top line is what I would say on the margin front. And certainly, as you look at

continued growth of companion animal outpacing the growth of livestock in the business, that mix will be favorable to us in addition to what I've already covered from a price perspective.

I think if you look at atopic dermatitis, we delivered \$1.3 billion of revenue in 2022. That's a 17% increase, and we're almost at 10 years since Apoquel was launched, and just amazing to see that we continue to expand the market. And we believe there is more room to expand, not only in the US where we grew 12% in 2022, but particularly in international markets where it takes longer to get to peak sales levels. And we've delivered 27% growth in International. I think we'll continue to see really solid growth across the business. We expect double-digit growth in 2023, though it may not be at the level that you've seen in 2021 where we grew, I think, about 23% and then 17% in 2022, but we continue to see room to continue to expand the dermatitis market here.

Operator: Our next question comes from Erin Wright for Morgan Stanley.

Erin Wilson Wright

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. So, two questions here. One, how much did the lingering supply chain issues impact Simparica Trio sales in the quarter, if at all, and how much did the stocking benefit offset that in the fourth quarter? And did you benefit across other product lines in terms of distributor stocking that we should be aware of in terms of that first quarter cadence as well? And just if you could talk a little bit more, maybe you touched on this with the gross margin dynamics, but in terms of overall price you are taking across the two core species segments here.

And then my second question is on Librela. Can you give us an update on the US Librela approval, and what does guidance assume in terms of US contribution from Librela. Is that material in 2023? Thanks.

Wetteny Joseph

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

A

Yeah, so let me first touch on your questions around supply in Trio as well as other products. As we said in the third quarter call, while we had some outages in supply during the year, particularly in the third quarter, competitors actually took advantage of that and ran promotions, and we certainly intended to run promotions as we recovered on supply, which we did in the fourth quarter. And so I think the timing of our supply recovery, whether it's with Trio in the US or for Revolution in China, will drive some stocking levels certainly as we enter into 2023, which we discussed.

But I think, typically, you'll see some increase in inventory levels from Q3 to Q4 anyway because distributors are anticipating our price increases and they tend to drive a little bit of that. So I would say when I look at across other products, it's probably more in the range of typical increase that you would see. But if you look at Trio, we're probably – if I had to bracket it in terms of the impact on Trio, if you back out what would typically be an increase from Q3 to Q4 anyway, so the incremental contribution in the fourth quarter I'd put somewhere in the \$25 million \$30 million range. So it's not a significant number for us. And certainly, as we discussed already, we factor that into our guidance and we expect significant growth from Trio on the year.

With respect to Librela, look, we continue to expect and are very confident that we will see an approval of Librela in the first half of the year. Our plans have not changed. We continue to plan to have an early experience program run on the program once we've gotten approval and we have the label set, et cetera, and then will transition into a launch sometime late in the year.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

And our practice – just to build on that, our practice on that is that we do not include in our guidance or our budgets if we're expecting a late launch in the year. We've always done that as – those who covered us for a while. So, Librela is not in our current guidance that we provided. We will update the guidance once we have a better sense.

Obviously, this is a big product, and when it launches, it could have a big impact. So whether or not you have one month, three months, et cetera, four months, it makes a big difference. So we'll update guidance once we have a better sense of that approval. So, to clarify your second question, Librela is not in the guidance that we provided. We fully do expect to have it, but we'll update our guidance once we have a better sense of what the exact timing is.

Wetteny Joseph

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

A

Yeah, and we'll give a better bracket in terms of what we expect the impact to be depending on the timing of the launch and what we see through the EEP program, et cetera.

Operator: Our next question comes from Louise Chen from Cantor.

Louise Chen

Analyst, Cantor Fitzgerald & Co.

Q

Hi. Thanks for taking my question here. So, I wanted to see if you could give more color on how you're investing in supply to meet the growing demand for your products, and when you exactly expect to complete or reach your objectives here. Thank you.

Wetteny Joseph

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

A

Yeah, I'll take that, and see if Kristin would add on anything. We are investing in a number of areas when it comes to our supply network. I'll [ph] quote (00:38:49) a couple of categories I see in the short – near term. We have investments clearly in inventory to help absorb any shock that comes through the supply chain. We're making investments in our demand planning processes and tools to give us better visibility, et cetera, as well as redundancies [ph] that we're building in and (00:39:06) certain aspects of our inputs coming into our manufacturing process.

Longer-term, as you may have listened on the prepared commentary, we're making significant capital investments across our network – across the network in the US to support our monoclonal antibodies, both for products that have already been approved and are launching and what we have in our pipeline as well from a mAb perspective. It is a platform that we continue to innovate on.

And then our oral solid dose as well, whether it's parasiticides, dermatology, et cetera, in various aspects, we are making investments throughout the network for those. We're making investments to support our vector vaccine manufacturing, for example, as well for livestock and so on. So we are making investments across the organization, as I said, in tech and digital to leverage data, again, to give us better visibility as well for the long term to support our long term growth aspirations.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

The only thing I'd build on there, Louise, is if you look at the CapEx number that Wetteny was talking about in his prepared remarks of \$950 million to \$1 billion, that is clearly the highest CapEx that we've had. But I also think you should look also at what we said about R&D. And as you look at significant new investments in R&D, those are going to be product that we're going to be able to manufacture in a few years.

So what you're seeing is the commensurate investment in our manufacturing capabilities to be able to launch those products in really critical platforms across the globe. So we are very confident in where our pipeline is, and we're going to invest in our manufacturing capacity to deliver on those products over the medium to long term.

Operator: Our next question comes from Nathan Rich from Goldman Sachs.

Nathan Rich

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good morning. Thanks for the questions. The first one on Trio. I'd be curious just to get a sense of what kind of factors you're watching as you think about the impact that competition could have and the magnitudes that would kind of push you to the higher or lower end of your range for competition. And are you anticipating any changes to pricing or your promotional cadence when competition enters?

And then my second question on Draxxin. Just how much of a drag will that continue to be in 2023? I think you've previously said that you'll start to cycle the second year of competitive entry in the first quarter, but I think there's been some more recent price changes. So just curious of what we should expect in terms of the impact on the livestock business this year.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure, Nate. I'll take the first question, and I'll let Wetteny take your second question on Draxxin.

Look, we've been expecting competition for long time on Trio, I would say. So I would say we are well-prepared for what that is. We've been investing heavily, obviously, behind DTC, really investing with our customers and with pet owners directly to make sure that when competition enters that we have very pleased customers.

And a few things I'll point to there. Obviously, it's our direct-to-consumer advertising. I would say our broad portfolio and our – as you look at our relationship with corporate accounts, we're very strong with corporate accounts. We are their preferred product, so I think that will provide some resiliency. But I'd also say auto ship remains a real strength. This is not a sector where people often switch unless there's a really good reason. So, a new dog, they'll make a choice, but they're not – I think customers who are already on our product are not going to be that inspired to change.

And if you look at the dynamics certainly in the US around retail, it grew 43% on the year. It's now about 11% of our US business. And I highlight that because the more that insulates us from potential new entrants coming and we obviously expect NexGard Plus. But I'm sure there will be others over the next one to two years that enter as well. So we're really investing in insulating ourselves from that impact by investing in pet owner loyalty programs, DTC, a broad portfolio with innovation with our customers wanting to do, corporate accounts I'd also underscore. And then, lastly, auto ship and strong relationships with the retail sector.

So, if you want to take the second question on Draxxin.

Wetteny Joseph

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

A

Yeah, absolutely. Look, as we said from the very beginning, we were expecting Draxxin to have about a 20% decline in the first year of generic competition and then another 20% in the second year. The first year was slightly better than our expectations, coming in somewhere around 16% decline, but the second year was little bit worse. So I think we're sort of in that ballpark.

I think second year was about 25%. So we're at a level now that once we lap, I would say the second year, which would be through the first quarter of 2023, which is why, in the prepared commentary, we said particularly in the first quarter, I think we're at a lower net level; it won't be as meaningful as an impact on us. And I think the drag on our overall livestock business won't be as significant.

So, I would still expect some pressure on livestock given where US cattle, for example, as a market is. We're watching swine, particularly in China, and the impact it has across other regions to determine where we end up landing. But we think livestock will be slightly down year-on-year, maybe marginally better than you saw in 2022 where livestock was down 2%.

Operator: Our next question comes from David Westenberg from Piper Sandler.

David Westenberg

Analyst, Piper Sandler & Co.

Q

Hi. Thank you for taking the question. So I want to kind of continue with some of the Trio dynamics. Can you talk about maybe if you got any word on in terms of what the label might look like on the competitive launch? And can you give a little bit more color? I think you said in the prepared remarks that you expect it to come from collars and topical. What are you kind of seeing in the marketplace that suggests that as opposed to other maybe legacy oral parasiticides?

And then kind of the second question here is on the increase in R&D spending. Are you going to continue to give out some of the – what you have in pipeline about – I think you guys usually give out six months in advance to Wall Street. Is that kind of still the expectation when you talk about pipeline? And thank you very much.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Hi, Dave. I'll start on Trio and then maybe Wetteny can clarify if there's anything I'm missing. And then I'll let Wetteny take the R&D question as well.

Look, we don't have any clear signs at what the label competition will be. We're very confident in our current label. We don't think it has any holes. I've got to tell you, we're at 100% heartworm protection, so I'm not really sure where you going to hit us on that. We've also been out on the market now since 2020 with this, which means we have a very strong set of safety data as well. So I'm sure, as always, competition will enter and they'll try to find any angle they can. But we don't really think there's any holes in our label right now that we're concerned about. We're in puppies if you look back to Simparica.

And the second part of your question, look, yes, will they move from single agents? I think they will. Single agents from just flea, tick or just heartworm products, I think will move into the combination label for sure. But we're not

expecting pricing to be a big factor initially. And really, that has to do with who is entering because if they don't enter the market similarly priced or higher than their current two products, they're going to cannibalize themselves. So I think really the power of whose entering does not lead us to believe that price is going to be a major factor in who enters. Obviously, we'll adapt to whatever comes, whatever label they have. But we remain very confident in our label, in our relationships and in our data today.

But do you want to take the second question on R&D, Wetteny?

Wetteny Joseph

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

A

Yeah. Look, the only small addition I would do to Trio is, we do get to 100% heartworm after the first dose. And with the product being on the market almost three years and satisfaction levels being very high and penetration across clinics, et cetera, we're very confident on our position as competition enters into the space.

On R&D, look, I think unlike human health, in animal health, there's not as much visibility given with respect to what's being specifically worked in the pipeline. We see that as a competitive advantage for us given our track record and how we continue to drive innovation in the spaces that we enter. And so, we won't necessarily be changing that significantly here in terms of what we have in here. But we have talked about various aspects of unmet needs, that if you were to ask veterinary practitioners what are the top 5 or 10 unmet needs that they have, I think you would imagine that we're working on all of those areas.

Operator: Our next question comes from Chris Schott from JPMorgan.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

Great. Thanks so much. I just had a question on the overall volume comments you made. I think it was 1% to 2% volume growth at the low-end versus 3% to 4% at the high-end. Can you just elaborate on the dynamics there? So how does that look for companion versus livestock? And maybe as part of that, what's implied in terms of vet visit growth this year? And is that even a relevant swing factor as you think of the overall outlook for the business? Thank you.

Wetteny Joseph

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

A

Yeah. So, look, I think if you look at our 2022 results, the net price contribution is about 3%. Now, if you take Draxxin out, that number is about 4% and companion animal would be at the higher number here, with certain products essentially above that. We're very pleased to be able to take price, which typically is about 2% to 3% and here in 2022 is about double what we would normally do. And we still saw about 5% volume growth in 2022.

So, as we look at 2023, I think you'd see price with Draxxin impact being less than it was in 2022, in particular. Plus, how we're going into pricing certain products, I think you can expect a higher price contribution on the year. The timing of that in terms of where customers may have bought ahead of the price increases and so on, so you might see a little bit of a lag in terms of when you see the price picture play out. But you'd see, at the low-end of our range, price is a bigger contributor. But, at the upper end, it's all additional volume.

In terms of where we see vet clinic traffic, certainly, we've seen vet visits come down versus the peak that we saw in 2021. In the fourth quarter, visits were down about 4%, but revenue per visit was up 10%. And total revenue

was up 6% on the quarter, again, continuing the trend that we see as being sustainable, which is pet owners willing to pay for innovation and seeing sustainably higher revenue for vet clinics.

Now, we're still very early in 2023. But, as we look at data in January, we are seeing some increases in vet visits, again, as we expected. We've been running above pre-pandemic levels. So, even in Q4 where visits were down 4%, they were actually still 2% above Q4 2019. And so, we've been saying that that's the element to continue to watch. I think one month is a little bit early to call it. But we are expecting visits to be flat to up in 2023 and we're starting to see some signals of that early in the year.

Operator: Our next question comes from Brandon Vazquez from William Blair.

Brandon Vazquez

Analyst, William Blair & Co. LLC

Hi, everyone. Thanks for taking the question. My first is just on the diagnostics side. You guys have, I believe, talked about this before, but maybe can you refresh us on where you are and some of the commercial changes, I think it was in the US where those are, and what that might mean for growth and potentially accelerating that business into 2023 plus?

And the other is just on China. You guys had a nice rebound there. I think you mentioned a little bit of supply coming back on the market, but maybe tempered that a little bit with COVID headwinds. So curious how those two shake out maybe a month and a half into this first quarter. Thanks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

Sure, Brandon. I'll start and let Wetteny build on both of them. So, in diagnostics, first of all, Wetteny and I are joining you from our national sales meeting actually out in Denver and I would say the energy in our diagnostics team is just amazing. So, as Wetteny mentioned in his prepared remarks, Q1, [ph] it was little bit (00:51:08) – we didn't have them on board until Q2 of 2022. So what we are expecting, as we look into 2022 (sic) [2023] as we get into the sort of middle to the year and the end of the year is really a return to at least market growth in the US if not faster.

We continue to see very strong growth in International as you saw from last year, and we expect that to continue into the year. So we're really excited about the new field force, having them on the ground, having them fully up to speed. Wetteny and I spent a lot of time with them yesterday, so I would say super optimistic overall in diagnostics returning to growth across the board, certainly, the IMAGYST platform and investments there.

And then I'll start on China and let's see what Wetteny has to build on it. We did see overall strong growth in the year of 11%. And we're optimistic so far year-to-date in sort of the return in China. We've seen both on the companion animal side, a really strong rebound there as we look into certainly, for us, our year is [ph] both (00:52:06) December and January. December, obviously, with the number – people homesick there was a little weaker, but we're seeing really strong rebound in January and we're looking, I think, at a strong year for us in China. Also, if you look at livestock, with opening up China, more return to eating out, to travel, to tourism, will not just be good for China to be honest with you, it could be good for livestock across the globe.

So it's one to watch. Obviously, there's huge uncertainty around China, not to mention geopolitical tensions and potentially UFOs these days, but we stand really confident in where we think China will be for the year, but it

remains a big risk both for China as well as for livestock across the board because I think a lot of – as China returns, they'll see China buying a lot of pork, poultry, beef, et cetera, from Brazil, Europe, the US.

But [ph] I don't know if you (00:52:55) want to build anything either on the diagnostic question or China, Wetteny.

Wetteny Joseph

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

A

No, look, it's great to be here in Denver with a large number of our colleagues on Valentine's Day. But look, I think China, we've been very pleased to see how China ended the year, high-double-digit growth on the quarter. My comments around supply was just the timing of recovery particularly on Revolution, Revolution Plus in that market that might create some dynamics from quarter to quarter. But we are expecting really solid growth out of China this year.

I think the first quarter though, given the timing of the COVID waves, just as a reminder, our International segment closes at the end of November, which means the quarter will be starting in December for them and so a lot of that occurred in the first quarter and we're seeing that having an impact, but we do see a rebound. And as Kristin said, it has implications for other markets in terms of exports into China but we are expecting a really solid rebound there.

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

Elliot Wilbur

Analyst, Raymond James & Associates, Inc.

Q

Thanks. Good morning. Wanted to go back to some of your early commentary around growth expectations for the key derm franchise and just specifically thinking about the key levers in 2023. Kristin, I wonder if you could maybe just talk about, especially given the high level of penetration of Apoquel in the US, what the key levers there are going forward, whether it be price, new market entry, geographic expansion or just outperformance by Cytoint relative to Apoquel.

And then, for Wetteny, I don't know if you said this in your prepared commentary or not. I didn't catch if you did. But, within gross margin guidance, could you just talk maybe about the inflationary headwinds that are sort of embedded in your guidance for this year? Thanks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. I'd say a few things on derm, both domestically as well as globally. We will be looking to expand, and I think as Wetteny said in his prepared remarks, reaching peak sales in some of these markets takes a little bit longer outside of the US. So we're continuing to see very strong growth in dermatology both in Apoquel and Cytoint, as well as lifecycle innovation remains really important for us here.

The movement to Apoquel chewable has been a real – it's been growing much faster than we expected, and the conversion there remains very, very strong. So I think it's both you're going to see growth in volume certainly, potentially, a little more globally. But, beyond Apoquel, I think Cytoint, vets really love it and so do customers. It's 100% compliance.

So I think if you look at the overall franchise, Apoquel, Cytoint, Apoquel chewable, we'll probably see greater growth outside of the US, so we're both looking at volume. We've taken price consistently here and, certainly,

2023 will be no different here. So I think you'll see growth from both price and from volume. You'll see chewable really building on it. I think you'll see a real uptick in Cytopoint. Again, we're back to Apoquel full supply. We, as you know, last year, did need to make some trade-off decisions there because [ph] it had the same impact (00:56:16) as our other mAbs and in some of our vaccines with regard to some of the COVID vaccine supply challenges we had.

But we're back full speed. So we're also really investing. Another big growth driver here will be direct-to-consumer advertising in International. So, we are going to do unbranded DTC as we started last year, and we're really – even in the US, there's still have 6 million itchy dogs that are currently undiagnosed and not treated. So we really continue to see growth here, as we said, double-digit, as Wetteny mentioned earlier.

But I'll let Wetteny take the second question, obviously, on inflation in 2023, [ph] et cetera (00:56:50).

Wetteny Joseph

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

A

Yeah. So, look, I think across the macro elements, we've been appropriately prudent in how we laid out this guidance in the range that we've given today. But, specifically on gross margins, if you look at inflation as we were preparing to come into the year, we are certainly accounting for significant inflationary pressure on some of our input costs, energy in Europe, et cetera.

But as we've entered the year, I think there are a little bit better than what we anticipated coming into the year, but still significant inflation that's baked into what we have here, which obviously are more than offset by our mix and our price, which is why you see some modest gross margin improvement year on year as we go through the year. But we have factored in fairly significant inflationary pressure in the gross margin figures that we gave.

Operator: And our last question comes from Balaji Prasad from Barclays.

Mikaela Franceschina

Analyst, Barclays Capital, Inc.

Q

Hi. This is Mikaela on for Balaji. Thanks for taking our questions. Just two from me. I guess could you firstly provide some additional color on business development priorities for the year? And then, building upon an earlier question, what are your volume expectations from new pet additions for the year? Thank you.

Wetteny Joseph

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

A

Yeah. So, look, when we look at our capital allocation priorities, certainly, investing in the business is the first place we go. And clearly, we are poised to significantly invest in the areas of R&D as well as across our supply chain and manufacturing. You saw the significant increase in R&D spend anticipated for 2023 versus 2022, and our CapEx numbers are going to be in the range of \$950 million to \$1 billion on the year.

Certainly, as you look at our strategic priorities, they align with where we look at from a BD perspective in terms of where there might be opportunities to accelerate some of those execution on our strategy, and they span across our current slate of businesses including some of the R&D areas in terms [ph] of actual (00:58:49) innovation and so on. BD is one of those areas, as you know, it's hard to predict in terms of exact timing and so on, but it is an important lever that I would say second after investing in the business. And then, thirdly, as you saw in 2022, we are returning capital to shareholders to the tune of \$2.2 billion in total between share buybacks and dividends.

I think you had a question in terms of – sorry. I think you had a question in terms of new pet. Look, if you look at the growth in the industry over the last two decades, it's been about 5% to 6%. The way I look at it, vet visits in essence as you see pet population growth and so on, it would be reflective in that. They have accounted for about 1% of that growth historically. So the bigger element of growth here is really pet owners' willingness to spend for innovation, and you see that reflected in the spend per visit figures that are far more in terms of the impact on growth historically, and we anticipate that continuing.

So, as we sit here today, I wouldn't say new pet increases is a major factor into what we're looking at. It's our innovation and pet owners' willingness to pay and the demographics of pet ownership, with Gen Z millennials willing to spend more on pet health and prioritizing those, as well as higher income households that are bringing more pets into their homes. Those are the factors that we watch that contribute to growth.

Operator: It appears we have no further questions at this time. I will now turn the program back over to CEO, Kristin Peck.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

Thank you so much, and thanks, everybody, for your questions and certainly for your continued interest in Zoetis.

And just to summarize, we see really positive and sustainable demand for our products based on the fundamental drivers of animal health. We see continued strength across our diverse global portfolio, especially in our products for pet care.

And we're continuing to invest in the talent, the pipeline and the manufacturing capabilities that can support our future growth while adapting our business to the increasingly dynamic environment where we operate. So we look forward to keeping you updated on future calls. And thanks so much for joining us today.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. You may now disconnect.

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