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Zoetis, Inc. (ZTS)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the First Quarter 2023 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. 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 the 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 for 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 first quarter 2023 earnings call. I am joined today by Kristin Peck, our Chief Executive Officer; and Wetteny 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, Thursday, May 4, 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 first quarter earnings call for 2023. Today we reported solid first quarter results of 4% operational growth in revenue, as expected, based on our diverse portfolio and strength in International markets. As we indicated in February, we expected a softer first quarter and a stronger growth for the remainder of the year, and we are reiterating our full year guidance for operational growth of 6% to 8% in revenue and 7% to 9% in adjusted net income given the underlying strength of the pet care market.

In the first quarter, our International segment led the way, growing revenue 10% operationally and was partially offset by a 1% decline in the US. Our livestock portfolio drove the results with 12% operational growth in revenue, while companion animal product revenues were flat operationally. The performance in livestock was based on double-digit operational growth for cattle, poultry, sheep and fish. In the case of US cattle, this performance was supported by an improvement in the supply of key products.

Meanwhile, our companion animal portfolio in the US declined due to distributors destocking and reducing their inventories in the first quarter as well as higher purchases in the fourth quarter of 2022, which occurred in anticipation of price increases and based on promotional programs. We see strong end market demand in companion animal channels based on data from veterinary clinics, retailers and pet owners. And we view distributor inventories as a short-term impact on our companion animal sales.

For example, while our sales into distributors declined in the quarter as we expected, our product sales from distributors out to veterinary clinics were up approximately 8%, and our product sales out of retail channels to pet owners were up about 35%, affirming a healthy pet care market in the US. Pet owner demand for products is expected to grow during the second quarter, pulling through more inventory and allowing purchase patterns by distributors to become more aligned with the underlying demand throughout the year.

Other dynamics in the US vet clinics also continue to show momentum and trending in a positive direction. Clinic visits increased 2% in the first quarter, showing an increase for the first time since 2021. Meanwhile, clinic revenue and average spend per visit continue to grow even in the face of inflationary pressures. Revenue and average dollars per visit increased 11% and 9%, respectively, in the quarter. The combination of evolving pet owner demographics, innovative medicines and an unbreakable human animal bond all continue to support a positive and growing companion animal market where we lead.

Despite the Q1 distributor issues in the US, our overall growth was driven by strength in International markets, which delivered 10% operational revenue growth in both livestock and companion animal portfolios. This quarter's results are a testament, once again, to how our diverse portfolio and geographic presence help deliver steady and predictable growth.

Turning now to adjusted net income, we saw a decline of 3% operationally in the first quarter, which was in line with our expectations. The first quarter reflected significant investments in our US pet care field force and shifts in the go-to-market model for diagnostics, costs which were not incurred fully in the year-ago quarter. We also saw increased investments in R&D, which we have discussed previously.

The investments in diagnostics are maturing and gaining traction in the US, and we continue to grow and expand outside of the US. We expect a return to growth in US diagnostics for the year as we build our VETSCAN IMAGYST AI platform, refine and grow our Reference Lab business and bring further innovative offerings to the space.

Looking ahead, we see strong demand driving double-digit operational growth for our innovative companion animal portfolio and relatively flat operational growth in our livestock portfolio this year. We will continue to invest in the franchises and capabilities that support our future growth, including large and growing product areas like parasiticides, dermatology, monoclonal antibodies, vaccines and diagnostics. For example, we continue to build out key product franchises through lifecycle innovations and claim extensions in products like Simparica Trio, Cytoint and Draxxin.

We are also expanding our global reach with approval in additional markets for new livestock vaccines like Protivity for beef and dairy calves; and Lawsotek for swine. And most recently, we purchased a manufacturing site outside Atlanta, Georgia, which will be used as a new monoclonal antibody vaccine and pet care product operation to add capacity for our expected growth. As you know, our monoclonal antibody and vaccine platforms are rapidly growing. And this new site would substantially expand manufacturing capacity for our biologics portfolio and ensure long-term supply across all global markets when it begins operations in 2026.

While the overall economic uncertainty remains a headwind globally in 2023, we have proven to be up to any challenge. We have learned valuable lessons and built new muscle, especially over the last three years, developing more agility, flexibility and resilience in our business and our people.

Despite the unusual mix of results in our first quarter, I continue to feel very positive about our full year guidance and how our diverse portfolio and vision for the future of animal health can drive long-term, sustainable growth and create value for our customers and shareholders. We will continue to be disciplined, yet adaptable in our approach to the opportunities, potential challenges and economic shifts that could occur throughout the year. We remain committed to delivering strong growth in 2023 based on our market leadership, innovative franchises and diverse portfolio, while continuing to invest for the future.

Thank you. Now let me hand this off to Wetteny. Wetteny?

Wetteny Joseph

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

Thank you, Kristin, and good morning, everyone. We had a solid start to the year with growth driven by our livestock business and strong International market performance.

Echoing Kristin's comments, our Q1 results are in line with our expectations. As we indicated on our Q4 earnings call, we expected the first quarter to be below the low end of our forecasted annual operational growth rate of 6% for 2023. In the first quarter, we generated revenue of \$2 billion, growing 1% on a reported basis and 4% on an operational basis. Adjusted net income of \$607 million declined 3% on both a reported and an operational basis. Of the 4% operational revenue growth, 5% is from price with a 1% decline in volume. The volume decline is driven primarily by US companion animal distributor destocking in the quarter.

Our livestock portfolio led the way in terms of species growth, growing 12% operationally, with companion animal revenues flat on an operational basis in the quarter. Livestock growth was broad-based with double-digit operational growth across cattle, poultry, sheep and fish. The growth in cattle was driven by additional supply of key products in the US. We saw growth in our poultry portfolio driven by higher sales of vaccines. Our sheep products benefited from favorable market conditions in Australia as well as our acquisition of Jurox in the fourth quarter of 2022. Finally, our fish portfolio continues to perform well with double-digit operational growth driven by strong vaccine performance in Norway.

Sales of our companion animal products were flat operationally in the quarter with growth in our monoclonal antibody products, Cytopoint, Librela and Solensia, offsetting declines in Apoquel, parasiticide and anti-infectives. Our monoclonal antibodies for osteoarthritis pain in dogs and cats, Librela and Solensia, posted \$51 million in revenue globally in the quarter with strong demand for both products. Additionally, Solensia benefited from our US launch in the third quarter last year.

As for Librela in the US, we still anticipate approval in the first half of this year, with a launch later in the second half. Simparica Trio posted global revenue of \$151 million in the quarter, representing an operational decline of 7% versus the comparable 2022 period. This was primarily the result of US distributor destocking during the quarter as well as pre-price increase buying and promotional activity during the fourth quarter. This decline was partially offset by growth in our International markets from increased clinic penetration and launches in new markets.

Our key dermatology portfolio declined 3% operationally with \$290 million in global revenue. This decline is attributed to the impact of pre-price increase buy-ins in the US in Q4 and in Japan in the comparable period in 2022. Cytopoint partially offset this decline with double-digit growth based on continued veterinary preference for injectables, which keep revenues in the clinic. Cytopoint better reflects underlying market demand due to our direct sales model on our dermatology portfolio and the lack of retail channel impacts. While we do believe conversion from Apoquel to Cytopoint may be accelerating, our overall outlook for our key dermatology portfolio remains unchanged. Our companion animal diagnostics portfolio declined 3% operationally, with declines in the US partially offset by growth internationally.

Now moving on to revenue growth by segment for the quarter. US revenue was \$1 billion in the quarter, declining 1%, with companion animal products declining 7% and livestock sales growing 15%. Companion animal performance in the quarter is reflective of the expectations we set in the prior quarter and is a result of distributor inventory and promotional impacts. As Kristin mentioned, demand for the veterinary market, as demonstrated by distributor sales to clinics, is healthy and growing. We continue to see robust sales outgrowth across our companion animal portfolio, including strong growth in parasiticides and our key dermatology products, and our outlook for the full year remains unchanged.

US vet practice trends are improving, with clinic visits up 2% in the quarter and clinic revenue growth up 11%. Average revenue per visit is up 9%. These trends are slightly better than we expected and largely reflect the normalization of the COVID impact on vet clinic visits. Total visits in the quarter remained above pre-pandemic

levels, and clinic revenues have grown on average of 10% annually over that period. Spend per visit remained elevated as the centers of care continues to increase.

Turning to product performance. The companion animal decline in the US was driven largely by decreasing sales of our parasiticides portfolio as well as key dermatology products. Simparica Trio posted sales of \$127 million in the quarter, declining 13%, driven by distributor destocking, partially offset by growth in patient share where we continue to outpace the oral flea, tick and heartworm market. Our outlook for Trio remains unchanged as we continue to see strong customer demand and continued conversion from topicals and collars.

Key dermatology product sales were \$184 million for the quarter, declining 5%. Apoquel sales were negatively impacted by high sales in Q4 ahead of our 2023 price increases and significant retail buy-in in Q1 2022. Cytopoint sales growth partially offset the Apoquel decline due largely to its injectable administration, which is preferred by clinics.

The US companion animal decline was partially offset by growth in sales of Solensia, which launched in the third quarter. We continue to see solid clinic penetration growth in Solensia and expect to drive awareness of feline OA through our DTC advertising campaigns.

US livestock grew 15% in the quarter, primarily resulting from our cattle business where we have improved several supply outages which impacted our revenues throughout 2022 and replenished our channel partner inventories. While we will continue to see benefit from improved supply, the replenishment impact is largely isolated to this quarter. We also saw growth in Synovex due to expanded label claims. Our poultry business also contributed to growth driven by expanded sales of vaccines.

Moving on to our International segment where revenue grew 3% on a reported basis and 10% operationally in the quarter, with companion animal and livestock revenue both growing 10%. Increased sales of companion animal products resulted from our monoclonal antibodies for alleviation of osteoarthritis pain, small animal parasiticides, as well as the impact of our Jurox acquisition, which was completed in the fourth quarter of last year.

We continue to be encouraged by the performance of Librela and Solensia. Librela generated \$34 million or 74% operational growth, driven by strong underlying demand and the removal of supply allocations that were in place for the first half of 2022. Solensia delivered \$9 million in the first quarter sales internationally, driven by stronger demand. Simparica Trio was the top contributor to growth for our International small animal parasiticides with \$24 million in revenue, growing 47% operationally due to expanding market share in the flea, tick and heartworm space.

Our International key dermatology portfolio was flat operationally in the quarter. We saw double-digit operational growth across most of our major markets, driven by higher compliance and new patients. However, this growth was offset by large pre-price buy-ups of Apoquel in Japan in Q1 2022.

Our International livestock segment also grew 10% operationally in the quarter, with growth in four of our five core species. Growth was driven by our cattle portfolio, which benefited from price increases in certain emerging markets. Our sheep business had an exceptional quarter with high demand in Australia due to favorable market conditions as well as the impact of our Jurox acquisition. Poultry also contributed to growth in the quarter with higher key account penetration in the Middle East and Eastern Europe as well as the benefit of price. And lastly, our fish portfolio continues to perform well, driven by growth in salmon vaccines in Norway. Swine was flat for the quarter with strong sales in China, partially offset by intermittent supply constraints in some markets.

Now moving on to the rest of the P&L for the quarter. Adjusted gross margins of 70.8% declined 80 basis points on a reported basis compared to the prior year, resulting from higher manufacturing costs and unfavorable product mix. This was partially offset by favorable foreign exchange and price increases.

Adjusted operating expenses increased 12% operationally, with SG&A growth up 11% operationally, driven by head count-related compensation costs as a result of our US small animal field force expansion, which largely began in Q2 of 2022, and higher T&E. R&D grew 19% on an operational basis, driven higher project spend for our pipeline candidates. Advancing projects include disruptive novel innovation and lifecycle management. R&D remains our first priority in capital allocation. Other income and deductions in the quarter are reflective of a favorable benefit associated with a settlement in the current period for prior period underpaid royalties related to sales of certain products.

The adjusted effective tax rate for the quarter was 20.5%, an increase of 160 basis points, driven by lower net discrete tax benefits in the quarter and less favorable jurisdictional mix of earnings, partially offset by higher benefit in US related to foreign-derived intangible income. And finally, adjusted net income declined 3% operationally and adjusted diluted EPS declined 1% operationally for the quarter.

Capital expenditures in the first quarter were \$223 million. We are still anticipating a significant increase in capital expenditures for the full year 2023. We continue to make investments to support our future growth, including manufacturing capacity for our monoclonal antibodies as well as oral solid dosage. In the quarter, we repurchased \$283 million of Zoetis shares and grew our dividend over 15% versus Q1 2022.

Now moving on to guidance for the full year 2023. As we have mentioned, the first quarter has gone largely as we expected. We are therefore reaffirming our 2023 guidance provided during February's earnings call. Note that guidance reflects foreign exchange rates as of late April. Foreign exchange rates have been volatile over the quarter. We will continue to monitor the impact of this volatility going forward.

For the year, we continue to expect revenue between \$8.575 billion and \$8.725 billion, representing a range of 6% to 8% operational growth. We also continue to expect adjusted net income to be in the range of \$2.49 billion to \$2.54 billion, representing operational growth of 7% to 9%. And finally, 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, both consistent with our February guidance.

Just to summarize before we go to Q&A. We remain confident in our ability to deliver on our full year guidance commitments and expect more normalized growth in subsequent quarters. We continue to see positive trends and solid fundamentals in the underlying demand and are confident that our innovative portfolio will continue to allow us to grow in line with or faster than the market.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll take our first question from Jon Block with Stifel. Please go ahead.

Jonathan D. Block

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks, guys. Appreciate it. Good morning. I'll ask both upfront. I think importantly, is the channel now normalized in the US, Kristin? And then some rough crude math, but if you were down 7%, US companion animal and sales out were up 8% [ph] show over (00:22:17) like a 1,500 basis point delta and I sort of landed over \$100 million in sales if you quantify that. So, can you guys bridge how you get there? I guess, there's a \$25 million to \$30 million of parasit last quarter. Are the distis working down inventory by a week. Whatever you can do to bridge that would be helpful.

And then a quicker one and easier one. Librela, I think you said approval still expected 1H. So launch 2H, is that the full launch, call it, before the end of the year? And then, again, Kristin, how do you feel in your ability to serve demand? We believe there is a lot of Solensia users that are chomping at the bit to get at it. So, do you expect US Librela supply to be an issue at all, call it, 1H 2024? Thanks, guys.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure, Jon. I'll start with your second question. It's pretty straightforward. Yes, we continue to expect approval of Librela in the first half with a launch in the second half. The timing of exactly that a full launch, obviously, we've always said, do early experience first and then go to full launch. So full launch could be very late in the year. But as we continue to – and I'll reiterate again, the Librela is not in our numbers for the year. We do not include in our numbers for the year a product that is expected to launch very late in the year for obvious reasons. So we would do early experience, as we've always done, with a full launch – if we did a full launch, it would be very late in the year based on what we're saying. And no, we do not anticipate any supply challenges on a full launch in 2024. Whether it's late this year or early 2024, we don't see any challenges there.

On your second question on distributor, I think we'll spend a bunch of time on that today. Obviously, there's a lot of complexity in that one. But again, it is in line with what we expected, and we really don't think the trend you see in the quarter is going to continue. Let me let Wettyeny get into all the details because I know this is probably the biggest question we've been hearing early this morning. So, Wettyeny, do you want to go through some of the details?

Wettyeny Joseph

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

A

Sure. Jon, the start of your question was, are we at normalized levels, I'll start there first. And yes, we are at normalized levels here sitting here in the second quarter. And let me just step back and give you a little bit more details here. As Kristin said, we came into the year and, as you may recall, on the last call we described how we saw increased buying in the fourth quarter driven by promotions that we ran on parasiticides given we had recovery of supply late in the year as we got through some of our supply constraints. And there was more pre-price buy-in given the level of price increases we're coming into 2023 with in the fourth quarter above what I would call normal levels of pre-price buy-in. So we expected to see destocking in the quarter, which is why we said that the first quarter would be below the low end of the range of growth that we have for the year at 6% to 8%.

So we've seen destocking in the first quarter down to, I would say, the lower end of our normal range that we've experienced historically. And by the way, given rising interest rates, that is not unexpected. And then as we got into April, we saw slightly more destocking as we started the quarter, but those have normalized and have been reflected in the guidance that we just reiterated today. And so, we're not anticipating a return back to normal levels in terms of inventory. So, our assumption in our guidance is that they'll stay about where they are now.

Now, to be clear, if you look at the end market demand dynamics, they remain very strong. As we said in our earnings release, sales out of distributors into clinics were up 8% on a volume basis in the quarter. And if you look at retail, sales out to pet owners were up 35% on the quarter. We've seen for the first time in about a year vet visit increase by 2%. And if you look at dermatology patients, for example, visits increased in the quarter versus a year ago. And so, again, we've seen normalization since then. And by the way, in International markets where we didn't see – we haven't seen and don't expect to see the level of destocking that we've seen in the US. We saw 10% operational growth in our International markets across livestock and companion animal.

And so, again, [indiscernible] (26:30) return to those levels, and these are factored into our guidance and were contemplated when we gave the initial guidance back in February.

Operator: And we will take our next question from Erin Wright with Morgan Stanley. Please go ahead.

Erin Wilson Wright

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. Two questions. One on livestock, one on companion. So, on the livestock side, was there a stocking benefit across livestock in the segment in the quarter? Can you quantify that for us? And how much the strength in US livestock should continue in the coming quarters given that you expect flat for the year?

And you touched on dermatology a little bit on the companion animal side, but you mentioned Apoquel declined with no competitors in that segment and your direct distribution strategy. What drove the decline? And does that volatility that you're seeing across that retail channel for this product change how you think about leveraging that alternative channel? And are you proactively shifting customers to Cytropoint ahead of competition? Thanks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Thanks, Erin. Again, livestock did grow 12%, as you mentioned, which was in line with what we expected. But the growth really was driven by resupply or increased supply of a lot of key products. As we reiterated in our prepared remarks, we continue to expect a flattish growth for livestock for the year. If you look at it, we saw – if you look at the US business, we think you'll see it's really more of a one-time sort of getting back into supply in some of this. Is it slightly up or slightly down? I think a lot of that is genuinely going to depend on China. With its return to travel and dining out in China will drive growth in a number of our markets around the world and our export markets such as Brazil or Australia or even the US. So we continue to expect and have built into our guidance for the year is to have a flattish livestock number, which obviously gets back to Wetteny's point, which is we are expecting very strong double-digit growth in companion animal.

As you look at dermatology for the quarter, it did decline, but this is largely due to the destocking of the pre-price buy-ins and promotions in the US. And as Wetteny mentioned in his remarks, the one-time issue in Japan back to Q1 of 2022, in fact, if you pull that out, International had double-digit growth if you take out Japan. So, again, this performance was in line with our expectations, but really importantly, it is not indicative of our view of our

expectations for the year. We continue to expect double-digit growth for the rest of the year and for the overall year for dermatology. Our sales out remain really strong. We're seeing a lot of uptake right now in Cytopoint. More and more pet owners are [ph] releasing (29:18) the compliance benefits of it, the efficacy of it, and vets love it because it obviously stays in the clinic. As we continue to see the shift here with compliance, I think again we'll underscore our growth there.

And the other thing I'd mentioned – that Wettyen mentioned is derm visits continue to grow in Q1, and we're not really seeing any pushback from customers on the price increases that we did do. So we continue to expect strong growth for derm for the year. Per our last guidance, double-digit growth for derm.

Wettyen Joseph

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

A

Yeah. I would just add the first quarter is not indicative of the year here, Erin, similar to the overall results. And so, to your point around retail channels, et cetera, we don't see us changing that. I think the fact that Cytopoint we expect to continue to lead the growth for our key derm franchise, we'll change the mix between those two, but not changing the overall picture. And our expectations for derm remain the same for the rest of the year. And we're off to actually a strong start in the second quarter for derm, both in the US and internationally.

Operator: And we will take our next question from Michael Ryskin with Bank of America. Please go ahead.

Michael Ryskin

Analyst, BofA Securities, Inc.

Q

Great. Thanks for taking the question, guys. First, I want to ask about the top line progression through the rest of the year. I think you'd pointed to some softness in 1Q previously, and you talked about just now, Wettyen, on what you saw in distributors to start the second quarter. But any additional color you could give us as sort of we go through the rest of the year, given there is a relatively steep ramp implied in the numbers right now just to hit your \$8.65 billion and 6% to 8% operational growth? So just talking about the step-up in 1Q to 2Q versus 2Q to 3Q, 4Q.

And then as a follow-on to that, Kristin, you touched on Librela earlier, but I was wondering if you guys could comment on the other product launch expected this year, the competitor to Simparica Trio. We haven't seen that yet. Obviously, can come any day, but I'm just curious what you're hearing on that and if your thoughts on what's going on in the parasiticides market have changed regarding to that in terms of what some of your competitors are doing with stocking, what some of your competitors are doing with promotions of some other products and sort of how that's affecting your view on para through the rest of the year. Thanks.

Wettyen Joseph

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

A

Hey Mike. I'll start with progression for top line for the year and then I'll turn it over to Kristin and she'll cover Librela launch and Trio competition.

So, with respect to progression for the balance of the year, we expect normalized growth across the year starting with the second quarter, which obviously we're already about halfway into the second quarter. And as I mentioned just a little bit ago, we got a strong start particularly in derm, but across the board to what I will call more normalized mix and normalized cadence for the balance of the year.

One thing I would say is, with respect to Q2, and that's normalized operational growth rate I'm referring to. If you take a look at FX, for example, that was about 3 points of headwind in the first quarter. Based on where rates are right now, I would expect about 2 points of headwind on the second quarter. So, when you math out operational growth to reported growth, you should take that into consideration. That turns around in the second half, again, based on where rates are now, and it ends up being slightly unfavorable on the year – year-on-year on FX on the top line and slightly favorable at the bottom line.

So that's how I would sort of think through the progression. But again, starting with the second quarter, you should expect normalized growth to get to the guidance that we just reiterated at 6% to 8%.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. And let me pick up your second question which was the other products. We are continuing to expect competition in the second half of the year for Simparica Trio, but I want to underscore that, as you look at the first quarter, we actually gained share. So, as we said, there's very strong underlying demand for Simparica Trio in the US, and even with competition coming, if you look at our performance, it was in line with our expectations. Again, we said it's not indicative of the year. And we continue to expect strong growth for the remainder of the year even with competition in the second half.

So we have been expecting this competition. The good news is, it's later than we did expect. As we think about it, we've talked about this before, we're not expecting them to radically change any pricing. Given they are the leader right now with HEARTGARD, NexGard, they would really cannibalize their own business. And I think it's important to keep in mind, even if you look at the quarter, they ran very strong promotions ahead of their launch. And even with those promotions, we gained share in that quarter. So we remain very confident in the strength of Simparica Trio, in the strength of our relationships with vets, and the pet owner satisfaction of it. We do expect competition. We think they'll bring a product, as I said, in the second half of the year, but we remain confident in the strong growth of Simparica Trio, as we said before, for the year.

Operator: And we'll take our next question from Nathan Rich with Goldman Sachs. Please go ahead.

Nathan Rich

Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks for the questions. Sorry to keep honing in on the destocking dynamics. But could you maybe just talk about how the first quarter US companion animal sales kind of played out month by month? It seems like January and February probably saw the bulk of the impact from the pre-buying and pull-forward into the fourth quarter. It sounded like the destocking might've occurred a little bit later in the quarter. I think just as people are looking to get better visibility on the improvement in the second quarter, could you maybe just comment on how March or April played out just as we think about kind of where the business is heading into the second quarter?

Wetteny Joseph

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

A

Yeah. So, look, I'll be happy to answer the questions in terms of the destocking. Look, we saw destocking from the start of the quarter just as we anticipated and as we discussed on the prior call, given the dynamics coming out of Q4. As we mentioned too in the last call, the timing of our supply recovery in terms of last year would have had an impact on the cadence on the year, which is playing out exactly as we thought.

I'll give you a little bit more color, perhaps, that might be helpful if you think about what the end market demand looks like. When we look at our sales out of distribution to clinics, we said it's 8% volume growth on the quarter. If you look at how those played out for March, the end of the quarter, they're actually above that number for us. So we haven't seen anything in terms of where the end markets are that would indicate a slowdown. And as I said, we've had a strong start to the second quarter, and we're sitting here in the middle of the second quarter and are saying that we would see normalized growth starting in this current quarter for the balance of the year.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Yeah. And I think I also want to reiterate what Wetteny said earlier, which is they are at very low levels, the lower end of their ranges. But our guidance expects that they do not go back up. We believe that given the current interest rate environment, our expectation is that they will stay at this level. So, again, our confidence in the guidance we're providing is assuming that they're not going back up, that they will stay at the levels that they're at now.

Operator: And we will go next to Louise Chen with Cantor. Please go ahead.

Louise Chen

Analyst, Cantor Fitzgerald & Co.

Q

Hi. Thanks for taking my questions here. So, wanted to ask you on your upcoming investor event, what will you discuss here? What are some of the key things that you're going to be going over? It's been a while since you've had an investor event. And will you be disclosing more additional pipeline products, longer-term guidance? Anything from that front? And also then wanted to ask you on your diagnostics business. What's the outlook for the remainder of the year on that business? Thank you.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. We are excited for our Investor Day. We've spent time talking to a lot of our investors over the last six months as to what they're looking about. Our focus there will be really on building confidence in our medium to long-term growth expectations. We've gotten a lot of questions, obviously, on our pipeline and R&D.

So you'll see us – as we mentioned in our press release, Rob Polzer, our Head of R&D, will be coming to give more detail on our R&D portfolio. And we also look forward to introducing you to other members of our leadership team, so you get to meet them as well. We're excited to share what we view as the short, medium and long-term growth aspirations and give you some confidence and more detail around all of those. So, Wetteny, do you want to take her second question on diagnostics?

Wetteny Joseph

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

A

Yeah. Happy to, Kristin. So, look, on diagnostics, we have seen increased productivity from our diagnostics team, particularly if you look at the US where we made the change about a year ago into the second quarter. In this first quarter, we actually saw very strong placements across our instruments, including [ph] IMAGYST (00:38:13) as well. Those will help drive growth from a consumables perspective as you look at the rest of the year.

Consistent with our guidance, we said we would expect to see improvements in terms of that – to the productivity, given the new field force and the change out that we did last year. And we would expect to see a return to growth in the US in the back half of this year. And again, we're lapping those changes that we made, which we firmly

believe are going to drive long-term growth for the business in addition to innovation that we continue to work on in terms of diagnostics.

Operator: And we will take our next question from David Westenberg with Piper Sandler. Please go ahead.

David Westenberg

Analyst, Piper Sandler & Co.

Q

Hi. Thank you for taking the question. So just on the Simparica Trio franchise and certainly distributor dynamics here. I usually think about the parasiticide portfolio as being heavy in the March to August season. As we take a step back or take a zoom-out look, do you think any of the dynamics that have happened with some of the distributor destocking is going to be a net negative for the annual sales of the product? Put another way, do you think maybe this impacts the timing of missing the flea and tick season and any of this kind of dynamic?

And then just to reiterate on the inventory question on the livestock portfolio, It doesn't have the same dynamics, right? So, I mean, like, the price increases in livestock were not the same as the price increases in companion. Therefore, you wouldn't see some of that same distributor dynamic. And then, if I could squeeze just one more. Just – I didn't see the inventory or the balance sheet yet, so just wanted to see if inventory levels trended up or down. Thank you. Sorry. That was a lot.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Let me start with Trio and then I'll let Wetteny take the other two. I want to underscore what we said earlier. We have very strong demand in sales out. And so, what you saw in Trio in the first quarter was a stocking issue. But as we look at the demand for the product and where it's going, it has no effect on the flea and tick season because we need it. We have full supply in.

I think what makes it is a little complicated and is unusual was the supply issues we had in Q2 and Q3 of 2022 put us – putting a lot more inventory into the channel at the end of Q4, trying to restock shelves against what we thought, as you remember, was going to be a launch in Q1 of a competitor. So, I think there's obviously some quarter-to-quarter stocking dynamics.

But I want to underscore, demand for this product remains strong. We gained share in the quarter. We are now at normal inventory levels. So, no, we do not see anything – if you look at the Q2 to Q3 of the product – and which we would agree; that is normally Q2 to Q3 is the strongest sales normally in parasiticides. So we continue to see very strong demand for the products. Obviously, there is some quarter-to-quarter stocking stuff that is relatively unique as you look at the end of 2022 and the beginning of 2023, but we don't think that actually signals to anything in the demand for the product or, importantly, the strong growth we see for the product for the year even, as we said, assuming competition in the second half.

Wetteny Joseph

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

A

Yeah. Look, I think there were a couple other parts to your question, I'll touch on in terms of livestock. We're not seeing the same dynamics in livestock. Look, I think if you look at where we ended last year, maybe we're in the middle of the range, towards the bottom of the range, might have been slightly increased in the quarter, given the recovery of some supply of certain products, as we mentioned in our prepared commentary. But overall, not any meaningful movement there to speak of.

And then with respect to our balance sheet on inventory, as you know, we are ramping up certain products, anticipating launch and approval of certain other products that will continue to drive inventories [ph] upward (42:03). If you look at operating cash flows on the quarter, they're actually favorable to last year because as inventories continued to increase, we saw really strong performance on receivables and AP. So overall, operating cash flows look favorable versus a year ago.

Operator: And we will take our next question from Balaji Prasad with Barclays. Please go ahead.

Balaji Prasad

Analyst, Barclays Capital, Inc.

Q

Hi. Good morning, everyone. Thanks for the questions. Couple from me. Firstly, could you give an update on the supply chain issues which impacted growth in 2022, be it on the vaccine side or Trio or monoclonals? And would you foresee or anticipate any supply chain issue impacting any of your key products this year?

Secondly, I wasn't sure I got the derm decline fully. This is not a distributor dependent segment. Can you provide some numbers around the derm segment and help us understand what led to the decline? Thanks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. I'll start with your first question on supply chain and maybe Wetteny can build on my derm answer from before. With regards to the supply chain, as we expected, we have completely normalized the supply chain. We always have some small level of challenges, as we mentioned before, in the biologics. But the challenges we saw in 2022 have been resolved, as indicated they would be. We're back into normal supply on these products. If you look at whether that's parasiticides or importantly our monoclonal antibodies, as expected, those are at normalized levels. We'll have some small number in bio, as we always have, and all of our competitors generally have. But supply chain has been normalized, and we don't foresee any specific supply chain challenges in 2023 going forward.

But maybe, Wetteny, you can build up on my previous comments on derm and see if you clarify some of those questions.

Wetteny Joseph

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

A

Yeah. I'd be happy to. So, look, the derm story is similar in terms of destocking from pre-price buy-ins that we saw in the US into retail in Q4. As well as a year ago, if you look at Japan, and if you look at our reporting last year in Q1, you'd have seen a significant growth rate for Japan in the first quarter, driven by those pre-price buyouts in Apoquel, and then you saw that go the other way in the second quarter. So if you were to, I would say, pro forma the results for the first quarter, taking into account what I just said, you would see double-digit growth for the derm franchise in both the US and International.

Operator: And we'll take our next question from Chris Schott with JPMorgan. Please go ahead.

Ekaterina V. Knyazkova

Analyst, JPMorgan Securities LLC

Q

Hi. This is Ekaterina on for Chris. Thank you so much for taking our questions. So first on price increases. Any feedback from the price increases in the beginning of the year? Are you seeing any pushback from veterinarians or pet owners? And any initial thoughts of how you'll be approaching price increases in 2024?

And then the second question is on diagnostics. Any thoughts on the proposed Mars Heska acquisition and the impact that will have on the diagnostics market? Does it change Zoetis's plans in diagnostics or the investments you're making in that market? Thank you so much.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Thanks, Ekaterina. I'll take your second question first and then let Wettyeny take your first question on the pricing.

I really think the Mars's acquisition of Heska confirms that the veterinary diagnostics market continues to be incredibly attractive investment area. Most importantly, it reinforces our strategy, we think, [indiscernible] (45:34) committing to execute it in the US specifically, building our Reference Lab network, and continuing to invest in innovation importantly in our point-of-care. We had a robust start to 2023. As we look at our IMAGYST, our Virtual Lab, our Reference Lab offerings, we believe it's resonating with customers. And really our focus is on leading with cutting-edge medicine, really rolling out our Virtual Lab which we really think is a differentiator. And we think that's what differentiates Zoetis overall, is innovation in the space, innovation around point-of-care, innovation in customer experience, and innovation in the Reference Lab. So, no. We really see that acquisition as reconfirming our strategy, and really we're going to accelerate our growth focus on innovative on diagnostics.

So, Wettyeny, do you want to take her second group of questions around pricing?

Wettyeny Joseph

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

A

Yeah. Sure. Look, we have not seen any pressure in terms of end market demand given our price increases. We took 5% price on the quarter. That's up versus 3% last year. If you look at the end market dynamics that we described earlier, you're seeing significant growth out from distributors to clinics. But also importantly, you're seeing significant growth from retail into pet owners, and we continue to see increased patient visits, for example, in derm, et cetera.

So we have not seen any resistance there in terms of price increase. And by the way, if you look at International, we grew 10% in companion animal in the quarter, given our price increases as well and despite some pre-price buy-in which is normal in the fourth quarter. So we haven't seen any signs of that. If you look at livestock, that actually marginally offset some of the price increases we would have seen in companion animal. We continue to see some impact on Draxxin, but not meaningful, not at the level that we've seen previously, as we just said. And actually we saw some volume offset to that, positively offsetting some of the price on the Draxxin side.

So, all told, good shape in terms of what we're seeing in terms of market reaction to our prices. And in terms of what it means for 2024, too early to tell. We won't go into that yet.

Operator: And we'll take our next question from Brandon Vazquez with William Blair. Please go ahead.

Brandon Vazquez

Analyst, William Blair & Co. LLC

Q

Hey good morning. Thanks for taking the question. The first one is just on guidance. You started off the year pretty strong despite kind of inventory levels creating a little bit of noise here. But if you kind of read through that, you're looking at, I don't know, like high-single-digits, maybe even double-digits operational growth to start the year. You reiterated guide for 6% to 8% operational growth. So, the question being basically, what would get you to that low end of that operational growth range, given the strength you're already seeing in the year if you kind of read through the noise?

Wetteny Joseph

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

A

So, look, if you look at the end market dynamics that we see, we see strength there. So I think that supports certainly the mid to high end of our guidance, I would say. If you look at what it means for the rest of the year, and I'll reiterate this point, which is we're already halfway through the second quarter. And again, we're seeing strong start to the quarter, and we'll see that normalized growth rate including mix, by the way, for the balance of the year. And keep in mind, right, our guidance didn't change including what we expect from livestock for the balance of the year. We went from saying livestock could be minus 1% to plus 1%. We're saying it's flattish. Basically the same thing.

So, Q1 has played out exactly as we thought essentially and therefore the rest of the year is the same. And so, no point in our guidance ranges any, I would say, more [ph] probable (49:16) than the other. We feel great about where we are on the year and how it's starting out for us in the second quarter in particular despite what you'd describe as the noise in terms of the inventory levels.

Operator: And we'll go next to Steve Scala with TD Cowen. Please go ahead.

Steven R Scala

Analyst, Cowen and Company

Q

Thank you. A couple questions. First, the new manufacturing facility in Georgia. Is the investment based predominantly on increased forecast for current products or positive late-stage R&D progress for which we at least on the outside currently don't have visibility? Or is it some combination?

And in the prepared remarks, you referred to disruptive novel innovation in the pipeline. Should we expect to get a window on that during the May meeting? And can you tell us if this is likely mainly directed at currently untreated diseases, more species, wider claims with an existing species, improved dosing, or something else? Thank you.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. The new manufacturing facility right outside of Atlanta, Georgia will be both to support current products and the growth in our current products as well as we'll target launching some of our new monoclonal antibodies out of that facility as well. It's a very large facility. It gives us tons of flexibility, which is what we found really exciting about the opportunity to be able to use it for lots of different things and really build a strong center in the south with a great labor market, really good access to a workforce that we think makes a lot of sense. So, we see the facility's ability to do both, and that is currently the intention. As I mentioned in my prepared remarks, we would expect it to be fully operational by 2026 and doing both at that point.

With regards to Investor Day, we will be looking at the whole portfolio. We'll give you more details which we've been asked for around the pain opportunity and what we're expecting there. We'll also talk about some of the new disease areas we mentioned before. We'll give you a sense of what we think those markets could look like. A lot

of those markets are new markets, so we'll help you size that market. We'll talk a lot about what our pipeline looks like and what we're doing there. So we'll give you information both on a species basis, importantly, on sort of key technologies, as we talked about in monoclonal antibodies, and then also, lastly, talk about some of these emerging big new markets that we think we can attack with some of our new novel technologies.

Operator: And there are no further questions at this time. I'll turn the program back to Kristin Peck for closing remarks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

Thank you. So, look, just to summarize, we really see a very positive and sustainable demand for our products. Based on what we talked about for a long time, which is the fundamental drivers of animal health, we are confident that Zoetis has the industry's most diverse and durable global portfolio. And this is really founded on innovative science, as we talk about, and supported by a high-quality supply chain. We'll remain focused this year and going forward on our five key growth catalysts: dermatology, pet parasiticides, pain, diagnostics and emerging markets. And we're going to continue invest in the talent, the pipeline, and the capabilities that support this future growth while ensuring that we can adapt to the dynamic environment that we all operate in.

And we really look forward to sharing more about this with you – our vision, our pipeline, our strategies for growth – at our Investor Day on May 25. And there, you'll hear more from me; Wetty; our Head of R&D, Rob Polzer, about the confidence we have in the animal health industry and, importantly, our ability to grow faster than that market and the investments that we're making to create that value for our shareholders. So, we announced the event this week, and I hope you can all join us virtually or at the New York Stock Exchange. As always, you can find more details about our Investor Relations information on our website. So thanks so much for joining us today.

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

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