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Zoetis, Inc. (ZTS)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Second Quarter 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] 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. Good morning, everyone, and welcome to the Zoetis second quarter 2022 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, August 4, 2022. 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 second quarter earnings call for 2022. I'm pleased to say Zoetis delivered another strong quarter with 8% operational growth in revenue and 9% operational growth in adjusted net income driven once again by the strength of our companion animal portfolio. We saw a balanced performance across the segment with similar operational revenue growth for both the US and international 9% and 8% respectively. Our diversity and strength across parasiticides, dermatology products, vaccines, and monoclonal antibodies for pain continue to demonstrate people's desire for innovative and effective care for their pets.

We continue to see positive spending trends across the globe for pet care, and we grew 14% operationally in our companion animal portfolio. As anticipated, our livestock portfolio continue to face challenges, declining 1% operationally in the second quarter largely due to generic competition, primarily in US cattle, and decline in swine products in China due to lower pork prices and COVID-related supply constraints. Overall, our business remains strong thanks to the durability of our global portfolio and a steady pipeline of new products. Even as we face uncertain macroeconomic conditions, continued supply constraints, generic competition, and the war in Ukraine, we remain confident in the resilience of our business and colleagues.

As we look to the rest of the year, we are updating and narrowing our guidance to reflect our positive outlook for the remainder of 2022 and the negative impact of recent changes to foreign exchange rates. Wetteny will walk you through the details in his remarks. As we look at the second half of the year, we remain confident in our long-term growth drivers and our ability to maintain a steady supply for customers despite inflationary pressures on the global economy and ongoing constraints for certain products. We all know pet owners love their dogs and cats and pet care remains a very positive and robust market, showing little impact from broader consumer concerns with inflation or the global economy.

As we expected during the pandemic, vet clinic visits are normalizing over time and spending continues to show strong growth based on the latest US numbers. The positive dynamics between pet and pet owners which I've spoken about before is proving sustainable and recession-resistant due to people's affinity for their pets and willingness to prioritize medical care for their pets and key demographic drivers such as the increased pet ownership by Gen Z and millennials and the greater percentage of high-income households owning pets. Our innovative companion animal portfolio is well-suited to address these customer needs.

Our key dermatology products continue to demonstrate strong growth, 22% operationally for the first half, and we see opportunity to expand in underpenetrated markets, especially internationally, and introduce lifecycle innovations like Apoquel chewable tablets. We have more to come in the pipeline for dermatology and we do not foresee any competitors for Apoquel or Cytopoint this year or in the first half of 2023.

In terms of parasiticides, the Simparica franchise, including Simparica Trio, is performing extremely well, having grown 47% operationally through the first half of the year and is gaining share in the industry's largest category. We currently anticipate a competing triple-combination parasiticide to be approved in the US in the next six months, with a possible launch next year. However, we believe Trio will continue to grow based on its strong label, proven efficacy and the support of DTC marketing in the US and international markets.

Our monoclonal antibodies for pain, Librela and Solensia, are performing very well in approved markets across Europe, and we remain very confident in the blockbuster potential of these breakthrough treatments.

In terms of the US, we have begun early experience trials for Solensia and expect a broader market launch in the fourth quarter. And we still anticipate approval for Librela later this year, assuming FDA inspections are completed at facilities outside the United States.

Meanwhile, our operational growth in international has remained steady throughout the first half of the year at 8%, despite COVID lockdowns in China and revenue reductions in Russia and Ukraine due to the war. Excluding the impact of Russia and Ukraine in the first half, our international sales would've grown 9% operationally.

This is the latest example of how our diverse portfolio and global footprint drives steady and sustainable growth for the business. While some markets may be experiencing setbacks in the quarter, other markets, like the US, Australia, Southern Europe and other emerging markets, are driving our performance.

In the second half, we see China returning to stronger growth if COVID stays in check, and we continue to expect the diversity across geographies and species to remain strong. In terms of livestock, we expect continued pressure from generic competition, primarily in US cattle and poultry products. However, we are generating growth across various livestock species in markets outside the US, and fish continues to perform exceptionally well.

Finally, like many companies, we are managing through supply constraints this year with certain products. We continue working hard to optimize our supply chain this year, so we can meet the increasing demand for certain key products.

Looking ahead, we will continue to invest in the resources, DTC marketing and manufacturing capacity we need to support our future growth and achieve results for our customers and shareholders. We are advancing our Driven to Care sustainability goals that were established last year, and we published our 2021 progress update and ESG metrics in the second quarter, highlighting achievements toward our DE&I aspirations, expanded climate goals, and support for the veterinary profession. We are committed to staying on our journey to be the most sustainable animal health company in the world.

We also continue to invest in R&D, business development and new capabilities across the business to enhance our portfolio and ensure our long-term growth. In the second quarter, we continue to receive approvals for new products like Poulvac Procerta HVT-IBD-ND; expand key franchises like Apoquel into new markets; and acquire new businesses to complement our portfolio such as Basepaws, a pet care genetics company.

In closing, our business continues to perform extraordinarily well in one of the most dynamic markets I've ever seen. Diversity, innovation and customer focus are our cornerstones for excellence. I want to thank our colleagues for their tenacity, commitment and resilience as we continue to deliver for our customers and shareholders. Thank you.

Now, let me hand things 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 very strong quarter with growth across a number of our core franchises and the continued resilience of our end markets. Today, I will focus my comments on our second quarter financial performance, the key drivers contributing to our performance, and provide an update on our full year 2022 guidance.

In the second quarter, we generated revenue of $2.1 billion, growing 5% on a reported basis and 8% on an operational basis. Adjusted net income of $567 million was flat on a reported basis and grew 9% on an operational basis. Of the 8% operational revenue growth, 3% is from price and 5% from volume.

Volume growth consisted of 6% from new products, which includes Simparica Trio and Librela; 2% from key dermatology products; while other in-line products declined 3%. The decline in other in-line products was expected and largely the result of the impact of intermittent supply challenges and generic competition for Draxxin.

Companion animal products continue to be the primary driver of growth, growing 14% operationally, with livestock declining 1% on an operational basis in the quarter.

Simparica Trio was the largest contributor to growth in the quarter. Trio posted global revenue of $237 million, representing operational growth of 72% versus the comparable 2021 period. We also continue to expand better than expected results from our Trio franchise outside the US, where we had sales of almost $30 million. We expect to continue to grow the addressable market for flea, tick and heartworm globally, and see significant headroom for growth with brands like Simparica and Trio.

Meanwhile, our key dermatology products, Apoquel and Cytopoint, had significant global growth again with $315 million of revenue, representing 16% operational growth against a robust prior year in which these products grew 22% operationally in the second quarter of 2021.

In Europe, our monoclonal antibodies for osteoarthritis pain in dogs and cats also meaningfully contributed to growth, posting $31 million in sales. Our global companion animal diagnostics portfolio reported $83 million in revenue in Q2, declining 9% operationally.

Growth in our international diagnostics portfolio was more than offset by a decline in our US business in the quarter. In the US, we experienced a decrease in sales resulting from our near go-to-market model and the build-out of a sizable and new dedicated field force for diagnostics. While disruptive in the short-term, this investment is putting the necessary fundamental elements in place to position and grow our diagnostics portfolio over the long run.

We expect the effectiveness of our new diagnostic field force to improve gradually over the remainder of the year. Diagnostics remains core to our business and a key long-term growth driver for Zoetis.

Sales of livestock products declined 1% operationally in the quarter. Negatively impacting growth across the portfolio were global generic competition for Draxxin and the war in Ukraine. China swine products again declined due to lower pork prices and COVID-related lockdowns. Our US poultry portfolio also continues to be challenged by generics and cheaper alternatives to Zoamix. Meanwhile, our fish portfolio began with double digits in the quarter and, along with the strength of our sheep products in Australia, partially offset the broader decline. Overall, livestock performance in the quarter continues to be in line with our expectations.

Now, moving on to revenue growth by segment for the quarter. US revenue was $1.1 billion in the quarter, growing 9%, with companion animal products growing 13% and livestock sales declining 7%. Focusing first on companion animal, US vet practice revenue trends continue to be positive with practice revenue growing approximately 5%. Spending per visit remained strong again this quarter, increasing over 7%. Visits declined more than 2% primarily due to challenging prior-year comparisons. In terms of vet clinic traffic, it is worth noting that visits in the second quarter were above the number of visits pre-COVID in the second quarter of 2019, and the trend line for growth in visits over the last several years continue to slow favorably.

I would also like to point out that our companion animal portfolio in the US had volume growth of 8% in the quarter. Our injectable portfolio of products that must be administered in the vet clinic also saw volume growth in the quarter. These products include Cytopoint, vaccines, and ProHeart. Underlying demand for veterinary care remains robust throughout the country even as people return to work. While labor challenges do exist, as they do across most industries, we believe vet clinic revenue will continue to grow at levels above what we were seeing prior to COVID as the standard of veterinary care continues to increase through innovation, better demographics, higher compliance, and more pets.

Companion animal growth of 13% in the US was driven largely by sales from Simparica Trio as well as key dermatology products. Growth of Simparica Trio was again strong in the quarter with sales of $208 million in the US, growing 74%. We are pleased to see that a significant number of Trio customers are new to the flea, tick, and heartworm category altogether. In addition, we continue to meet our clinic penetration targets and take share within individual clinics. These dynamics will provide additional runway for future expansion of both the broader market and revenue growth for Trio.

Key dermatology product sales were $219 million for the quarter, growing 11%, with Apoquel and Cytopoint each significantly contributing to growth. Year-to-date, our derm portfolio grew 16%. Our investments to support our derm portfolio have been instrumental in driving more patients into the clinics, and we'll continue to invest meaningfully in this space as a large portion of dogs with dermatitis remains undertreated, representing an opportunity to further expand the market. US livestock declined 7% in the quarter driven primarily by sales of cattle products as a result of generic competition for Draxxin. Meanwhile, our poultry portfolio continues to be negatively impacted by the expanded use of lower-cost alternatives and generic competition for Zoamix. Swine product sales grew in the quarter as a result of increased disease prevalence and favorable market conditions for producers.

Moving on to our international segment where revenue grew 2% on a reported basis and 8% operationally in the quarter. Companion animal revenue grew 16% operationally and livestock revenue grew 2% operationally. Increased sales of companion animal products resulted from growth of monoclonal antibodies for alleviation of osteoarthritis pain, our key dermatology products, and the Simparica franchise. These core brands continue to benefit from our international direct-to-consumer promotional campaigns and we remain excited with the long-term prospects of these programs.

We continue to be pleased with the performance of our monoclonal antibodies for OA pain, with Librela generating $26 million and Solensia delivering $5 million in second quarter sales. Librela remains on track to exceed $100 million in revenue this year. As we have mentioned in prior quarters, Librela is the number one pain product in the EU, with the underlying performance metrics being very favorable for future growth. The ordering rates remain high, compliance continues to exceed our initial expectations, and we continue to see significant opportunity to expand the pain market with a meaningful percentage of dogs on Librela being new to the market.

It is also worth noting that we're observing similar pet owner and vet clinic trends in many of our key international markets that we are seeing in the US. The higher standard of care and better demographics as well as the more rapid adoption of innovation continues to expand markets for our products, and we expect these trends to continue. Volume growth in our international companion animal portfolio was 10% in the second quarter, and we also saw growth across our injectable products including monoclonal antibodies, vaccines, and Cytopoint.

Meanwhile, international livestock grew 2% operationally in the quarter with solid growth across fish, cattle, and sheep. Our fish portfolio experienced increased demand for vaccines in key salmon markets, including Chile and Norway. Cattle grew to favorable market conditions and price in key emerging markets, including Australia, Turkey, China, and the UK. Sales of sheep products grew as a result of favorable market conditions and new product launches in Australia. Growth was partially offset by continued weakness with the price of pork and COVID-related supply challenges in China as well as unfavorable producer rotational programs with MFAs in Europe and reduced box sizes in Latin America impacting poultry.

Now, moving on to the rest of the P&L for the quarter. Adjusted gross margins of 69.8% decreased 120 basis points on a comparable basis to the prior year, resulting primarily from unfavorable foreign exchange impacts as well as higher manufacturing, freight, and other costs partially offset by favorable price and mix. Adjusted operating expenses increased 10% operationally, with SG&A growth of 8% operationally, driven by promotional and marketing expenses related to key brands and new product launches as well as T&E costs beginning to return to pre-COVID levels. R&D expenses increased 16% operationally due to higher compensation costs, increased spending on projects, and higher operating costs.

The adjusted effective tax rate for the quarter was 20.7%, an increase of 70 basis points driven by changes in jurisdictional mix of earnings and lower discrete tax benefits related to share-based payments. And finally, adjusted net income grew 9% operationally and adjusted diluted EPS grew 10% operationally for the quarter. Capital expenditures in the second quarter were $146 million. We are still anticipating a significant increase in capital expenditures for the back half of 2022 primarily related to investments in Ireland, the US, and China to support manufacturing capacity needed to meet our long-term growth demands. In the quarter, we returned over $600 million to shareholders through a combination of share repurchases and dividends. We repurchased approximately $450 million of Zoetis shares, representing our largest share repurchase ever.

Now, moving on to our updated guidance for the full year 2022. For operational revenue growth, we are maintaining the midpoint and narrowing the range of growth to 9.5% to 10.5%, previously 9% to 11%. We are increasing our operational growth expectations for adjusted net income to a range of 11% to 13%, previously 10% to 13%. This change in guidance signals an increased confidence in the back half of the year due to the continuing outperformance of companion animal, easing of certain supply constraints, and an improvement in our business in China. Please note that our guidance for adjusted interest expense and OID was changed to reflect favorable changes to interest income. Foreign exchanges rates on our updated guidance are as of late July and reflect the continued strengthening of the US dollar.

Beginning with revenue for the full year 2022, due to the narrowing of our range and the impact of foreign exchange, we are now projecting revenue of between $8.225 billion and $8.325 billion. We now expect adjusted net income to be in the range of $2.35 billion to $2.39 billion. And finally, we expect adjusted diluted EPS to be in the range of $4.97 to $5.05 and reported diluted EPS to be in the range of $4.65 to $4.75. While our guidance represents our outlook for the full year, due to the unique factors impacting our business in 2022, I would like to note that our guidance for growth, especially for revenue and adjusted net income, will be rated towards the end of the year. While we expect operating expenses to be incurred at a similar rate across the back half of the year, we are noting an easier OpEx comp in Q4 than Q3 due to heavy spending in the fourth quarter of last year. Also, in Q3 of last year, we experienced an unusually low adjusted effective tax rate of 16.7% due to favorability related to foreign-derived intangible income and certain discrete items. We do not expect similar favorability this year.

Our full year 2022 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 over the long-term. Our success will continue to come from our diversified portfolio of enduring brands driven by multiple sources of in-line growth, productive innovation, and an infrastructure to develop and extend markets globally. We expect to continue to execute across multiple dimensions of our business and capitalize on favorable end market dynamics for the foreseeable future.

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 Michael Ryskin of Bank of America.

Michael Ryskin
Analyst, BofA Securities, Inc. Q

Great. Thanks for taking the question. I'm going to try to squeeze in two real quick. First, on your comments on the Trio competition, Kristin, certainly something that's been talked about and anticipated for a while. But I'm curious if you have any updated thoughts on how you'll respond. Is there going to be a change to how you price Simparica Trio, or any additional promotion or DTC plans you can try to implement in the next six months? And I'm wondering if it's too early to give us maybe a ballpark dollar target for next year? Is it crazy to think that you could hit $1 billion in Trio sales in 2023?

And then, a quick follow-up, if I can. On margins for the year, Wetteny, I'm hoping you could – can you walk us, ex impact to margins, both on gross margin and OpEx? Just wondering how that factors into the updated outlook. Thanks.

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

Sure. I'll take the first one, Mike. Thanks for the question. For starters, we were really pleased with the performance of Simparica Trio and Simparica franchise in the quarter with 72% growth, and we do expect, even with competition, to grow the franchise here. What we're really seeing in the market is a strong shift from topicals and collars to orals as the new standard of care, so we see the category certainly growing.

We still believe we've got some number of advantages for being first-to-market. We've gotten a lot of customers enrolled in auto ship, which is really helping continue to drive growth there. We've got strong relationships with the large corporates. But importantly, on that issue, we still believe we've got significant room to expand in our penetrated clinics as we look at where our penetration within those clinics is.

The other thing is we really don't believe you're going to see tons of switching without significant differentiation, which, honestly, we're not really expecting. This remains a significant market. And right now, the Simparica franchise is number two in the US in flea, tick and heartworm. So we are expecting approval of a potential competitor sometime in the back half of this year and then, obviously, launching likely sometime next year. But we continue to believe that we can grow the franchise. We're going to invest highly in that through direct-to-consumer, through our field force. And we believe, given all the issues and opportunities we have, we can continue to grow this franchise.

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

A

Yeah. And Mike, your question on margins and OpEx. If you look at our gross margins on a year-to-date basis, if you take out the impact of FX, we're running about 20 basis points above last year. So in the quarter, you saw gross margin down about 120 basis points. That's all FX-driven. We've effectively maintained our OpEx growth range in our guidance, and we're able to raise the bottom line guidance to 11% to 13% versus 10% to 13% that we started the year with. So, again, FX is having an impact here, but we are executing according to our plan and we'll see an improvement even on the bottom line growth rate.

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

Erin Wilson Wright
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. Could we get an update on Librela, both the US approval and the supply chain constraints for that product in international markets? At this point, do you think you have visibility if supply chains constraints will have any sort of impact on the US launch in terms of timing? And after you do get approval in the US, will you be ready to broadly launch that product immediately?

And then, just in terms of the guidance, how should we be thinking about what's embedded in the guidance for companion animal and livestock growth for the balance of the year? Are there any sort of dynamics of a quarter-to-quarter basis that we should be thinking about? Thanks.

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

A

Great. Thanks, Erin. I'll take the first one and let Wetteny take that second question. We are really pleased so far in the Librela success outside of the US, and we'll talk a little bit what I think the implications therefore are within the US. Right now, Librela is the number one OA pain product in dogs in the EU already, which we think is outstanding. If you look at its success, it's really been embraced and we see very strong reorder rates right now. Really impressively, 40% of dogs are new to the category and we're seeing a 90% reorder rate. So we're really pleased.

This is a product, as you've noted, that does share some components with human COVID vaccines. And we have been managing that very carefully, making sure as we launch that we have adequate supply since this is a chronic medication. We really have been thoughtful about that. We do believe we've got additional capacity coming online at some of our suppliers as we look into the second half this year and into next year.

So, as we look at the rest of this year, as we said, we believe this product will be a blockbuster this year, over $100 million. And we're very optimistic, assuming we get the approval as we're expecting and an inspection this year, to be able to move exactly as we did in Solensia next year with an early experience in the first half, followed by a full launch.

So remain very excited, investing heavily behind it, and believe we're working hard on the supply chain. Unless something changes dramatically, we're confident we will have the supply we need for a successful launch in the US next year.

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

A

Yeah. And Erin, with respect to our guidance and how you should be thinking about companion animal versus livestock. So far year-to-date, we've delivered 9% operational growth at the top, line largely driven by companion animal. I think you can expect that to continue in the back half of the year when you consider, as Kristin just mentioned, Solensia will be fully launched in the second half in the US here. We'll continue to see growth in Trio. And with Librela which we expect to be a blockbuster in EU this year, we delivered $21 million in the first quarter, $26 million in the second quarter, so that will continue to ramp. So, I think those will contribute towards companion animal continuing to drive.

When I think about livestock, we do see easier comps in the back half than we would've had in the first half. If you recall swine in China for example, prices started to really decline in the second half of last year, so that becomes an easier comp when you think about Q3 and Q4. And as for cattle, we did have some price adjustments in the fourth quarter last year on Draxxin leading into the start of the year, so those make for slightly easier comps from a cattle perspective in the fourth quarter. So, those are some of the considerations, but I would expect the second half to look more like the first half in terms of contribution from companion animal compared to livestock.

Operator: Our next question is from Jon Block of Stifel.

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

Q

Great. Guys, thanks. Good morning. I'll try to ask two long ones up front. Key derm, I think, was up 22% operationally in 1H, but I think it slid from 27% in 1Q to 16% in 2Q and I got a sort of a similar year-ago comp. So can you talk to, Kristin, your thoughts on the atopic derm growth, call it just the trajectory going forward? Does the chewable version offer a price premium for you guys? And I think, Kristin, you also talked about just no competition for maybe the next 10 months. Just how you have that line of sight? And then, shifting gears, second question to livestock. That market just always seems to be evolving. Would love to get your thoughts on normalized growth returning to the industry in 2023. Kristin, I think you called it out last quarter. Does that stay intact? Would your growth be representative of market since I think you're going to get it soon on the back end with some of the generic headwinds that you've been pacing? Thanks, guys.

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

A

Sure. Thanks so much, Jon. I'll take the first question and let Wetteny take the second one on livestock. We are very pleased with continued growth of the derm. To your point, in the first six months of the year it grew 22%; in the quarter it was 16%. There always has been some cyclicality, but we really believe we can continue to grow this franchise. We can expand it as we have been through both branded and unbranded DTC. As you know, we just began this year really an investment in unbranded DTC in Europe where we're now seeing significant pick-up there. We continue to see people home with pets more. And importantly, there are still in the US alone 6 million dogs who are still itching who have not received a product, so we think we can continue to grow this.

To your question on competition and lifecycle innovation, we are investing heavily behind lifecycle innovation. This is our category. As you saw last year, the franchise is already worth $1 billion, so we will work heavily to defend this both with chewable and with other products in the pipeline. Chewable is a real advantage for a lot of people who have trouble giving pills to their dogs and getting them to take it. I would say there may be a slight price depending on if it's very market specific as you look at the pricing there. But to us, it's really building the loyalty to our franchise overall.

We don't have competition as you know it's not a perfect science in our industry. But as you saw on Simparica Trio, we do see competition. Mostly, that is through working with chatter in the marketplace as well as with distributors and our large corporates who start negotiating differently with us when they believe there's going to be competition in the space. So, we are not seeing that in the same way that we are just starting to see that now on competition for our Simparica Trio franchise. So, we continue to believe we can grow this franchise with new innovation, with the strength of our commercial infrastructure, with our investment in DTC.

So, I'll let Wetteny take the second question on livestock.

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

A

Yeah. When you look at livestock, historically, we've seen livestock grow around the 4% range. Certainly, you're very familiar with what's happened in the last few years in terms of ASF. And for us, with generic competition with Draxxin and Zoamix, the year is essentially executing as we expected on livestock. We continue to believe that we can see livestock returning to normalized growth in the 2023/2024 timeframe. And long-term, when we look at livestock, we continue to see growth in this business long-term given population growth. We see urbanization as well as a growing middle class particularly as you look across emerging markets.

And even in this year, if you look at this quarter for example, livestock grew 2% internationally despite the headwinds in swine. As I said, those comps get easier in the back half. And if you look at Russia-Ukraine for example, another point there, so we're seeing growth in emerging markets on livestock. We expect those to continue long-term with innovation as well as we continue our swine vaccines that we are launching, vector vaccines on the poultry side, immunotherapies in cattle, etcetera. We would expect to continue to drive growth in livestock long-term.

Operator: Our next question comes from Christine Rains of William Blair.

Christine Rains
Analyst, William Blair & Co. LLC

Q

Hi. Thanks for the question. Just piggybacking off of that last point, can you further review those pipeline highlights in the works for your livestock portfolio? And just related on the comparatively well international growth in livestock this quarter, can you discuss the factors there that drive the different performance between international and domestic here? Thanks.

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

A

Yeah. Sure, I'll be happy to do that. Look, I think as we enter the year, we expected given the second year of generic competition for Draxxin, our largest product in cattle, and to some extent in swine as well, we expect that to drag our livestock performance in the US, and again that's essentially executing as we thought. What that is masking somewhat is the innovation that we are launching in swine for example with vaccines in swine or vector vaccines that we have been launching will continue to drive in livestock as well. But we are seeing growth in emerging markets. You saw 2% growth in the quarter but again, that was offset partially with the Russian and

Ukraine impact here given the conflict there as well as swine. As you know, from the second half of last year we've seen a decrease in price that has impacted the performance there, although we have seen a lift in prices on swine over the last number of weeks or months in China, and we expect that to continue as we execute through the second half of the year.

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

A

Yeah. I'll take a little bit more on your question on the pipeline in livestock. To build on what Wetteny is saying, we do continue to believe that there's significant growth opportunities in vaccines in livestock; that's what our customers are looking for. As Wetteny referenced, we've been launching some vaccines in swine. Certainly, vector vaccines, we just announced approval of a second vector vaccine. In poultry, we'll be launching more vector vaccines in that poultry franchise as well. Really excited as I mentioned earlier about fish with 23% growth in the quarter; Alpha Flux really focusing on sea lice and other potential vaccines there. And then, if you look at that more broadly as we look out a little farther, investment in immunotherapies as well as in precision livestock farming, continuing to add to our BLOCKYARD product there, to our genetics business there.

So, we do see a number of key platforms in livestock to drive innovation in the space. As Wetteny said, I think you can get back to the historical growth rates of around 4% as we hopefully lap some of this generic issues around Draxxin and Zoamix in poultry and the ASF issue in China. But I think to get above that, which we certainly aspire to do, is going to take bringing innovation and we are certainly investing to be the leader in innovation in livestock.

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

Nathan Rich
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Good morning. Thanks for the question. Kristin, you talked about the capacity and labor constraints that clinics are facing, but I think you noted vaccines and injectable products continue to grow. I guess, can you maybe talk to your ability to continue to grow those products in the current market backdrop? And I guess ultimately, the bigger-picture question is if we see these market dynamics both from a macro standpoint as well as some of the pressures the vet clinics are facing continue into next year, I guess how should we think about growth? I guess should we expect a similar level of companion animal growth as to what you're guiding to in the back half? Thank you.

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

A

Sure. I think what's important to keep in mind is that vet clinics are doing quite well. If you look at growth in vet clinic revenue since 2019, it's up 20%. There's definitely a 5% increase in the number of pets in the US; there are capacity constraints to meeting all the needs. But I think what's important to remember also is we're not leveraged as highly as some other businesses to in-clinic visits. A lot of our key products are chronic, so if you look at our derm portfolio, our para portfolio, etcetera, we're still seeing tremendous growth. We had a 10% volume increase in the quarter in US products, so I think it's important to think there's more movement to online and other spaces. So, we don't see some of this capacity issue as a major issue for us in continuing to grow our business.

You're seeing some of the same capacity constraints in Europe and yet you're already seeing us have Librela looking to be a blockbuster product this year. And I think what really differentiates us is innovation. When there's important science and new products vets are excited about, we're still seeing great attention at the vet clinic for that and really driving that through. Although a lot of people are very focused on vet visits given we're not as leveraged to that, we really think the spend per visit is really important and I think we're leading in that category given innovation.

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

Louise Chen
Analyst, Cantor Fitzgerald & Co.

Q

Hi. Thank you for taking my question here. Wanted to ask you are there any metrics that you can point to to support price and demand elasticity in the pet health space? And then, do you think about this the same way in livestock? Thank you.

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

A

Well, I think, certainly, when we look at price and demand, we've continued to see us try and take price at or above inflation, and we've demonstrated that over the years, particularly in certain markets. We've also looked at data in terms of pet ownership and demographically, we see the structural improvement I would say even compared to very strong basis to begin with. So if you look at pet ownership with respect to Gen Z and millennials, and they're prioritizing pet health that certainly bodes well. But also, we're seeing more adoptions at higher income households if you look at what adoption numbers look like over the last number of years, which, again, is structurally very positive for the industry.

So as we've taken price over the years, and we took about 5% price in companion animal this year. Overall, for the company, we've been running at about 3%, net, given some of the livestock dynamics, particularly Draxxin generic competition. But we have been able to take price and yet, we still continue to see strong volume growth across the business. And to Kristin's point, that's largely driven as well by innovation in the space, so we continue to see elasticity in terms of ability to take price at or above what we see from an inflationary perspective.

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

Elliot Wilbur
Analyst, Raymond James & Associates, Inc.

Q

Thanks. Good morning. Just a follow-up question for Kristin around parasiticide trends in the quarter. Can you maybe just talk about category growth overall? It seemed like some of the metrics out there suggested that overall category growth had actually been down, and obviously Trio continues to perform extraordinarily well particularly in the US. But we're thinking about the second half of the year and then early next year with a potential entrant what you're seeing in terms of category growth? And if you could just give us the number in terms of where Simparica is with respect to overall share in the category.

And if I could just get a quick follow-up in here on Librela. Obviously, the initial EU experience has been quite positive here. I think you mentioned that 40% of pets were new to therapy. Just wanted to get maybe an update in terms of what you're seeing with respect to persistence, some of the pets that started therapy initially, and sort of what kind of persistence rates you're seeing sort of six to seven months after beginning therapy. And is that 40%, is that sort of a normal number in terms of new pets coming into the market or should the takeaway there be that Librela sort of has really kind of elevated the overall category growth? Thanks.

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

A

Thanks, Elliot. I'll start with your Librela and see if maybe Wetteny can add anything on the para point. Really good questions there on Librela. If you look at the 40% new to the category, we do think that's extraordinary. This is an established category. This isn't like derm when we started it where it wasn't really a category. There have been many products across the globe for dogs for pain management, but I think it really underscores the challenges with the existing therapies. The trade-offs in safety and efficacy have been significant.

Most of those therapies you can't stay on for very long, and I think – so for a lot of people that really didn't want to deal with some of those side effects, they had stayed out of the category. I think with the label that we have with the monoclonal antibody, we are clearly bringing new people to the sector and we're growing that sector significantly.

I think we talked about before the global market for pain for dogs was around $400 million. We believe, with the addition of Librela, that we can double the size of that market over time and move that to $800 million. And we think we can do that from a few ways, and one of them you referenced. One is people staying on therapy longer. Certainly, with a safe and efficacious product, we believe we can increase days on therapy.

I think we can also, as we demonstrate with 40%, increase the number of pets getting it. And third, we think we can grow the market certainly based on price, as this is a premium product with significant innovation.

So we are really pleased with the 40% growth. It is certainly higher than even we were expecting with the new patients to the category. We're seeing significant – probably higher than we were expecting initially – compliance in the sense of months on therapy. So we remain extremely optimistic about EU and the persistence of this growth.

And I'll let Wetteny take your follow-up question on para trends.

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

A

Yeah. When we look at the category, broadly speaking, clearly, Trio grew 72% in the quarter. If you look at our overall Simparica franchise, grew 47%, right? So if you look at Simparica – not Trio, but Simparica - internationally, it grew 23% in the quarter. So we have the broadest offering in terms of parasiticides in the industry and, clearly, the only triple combination in the US. What we are seeing is – categorically, we're seeing a shift from topicals and collars to oral medications. And if you look at triple combination in the US, one of the interesting statistics that we've seen is that on Trio, about 30% of the dogs that are coming on Trio are new to the category, not having been prescribed a prescription – a parasiticide in the prior 18 months or so.

So we do see significant room to continue to expand in this space. And as competitors come into the space, there will be more DTC that will drive even more patients to the clinic, which is beneficial for us as well, given our relationships across corporate accounts and so on. We'll benefit from having more voices out driving more patients into the clinic. So we're not seeing a slowdown in the category. There is a bit of a shift from the topicals and collars into orals, and that benefits us given our premium products.

Operator: Our next question comes from Balaji Prasad of Barclays.

Balaji Prasad
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning and congratulations on the results. Two for me. Firstly, as we've talked to lapped impact of generics on Draxxin and Zoamix, would you still count threat of generalization as a top-two or top-three challenge over the next two years? And if you can also add some broader comments around the percentage of your portfolio exposed to generic competition over this period. Also, on diagnostics operational decline of 9%, it seems to be the first quarter of decline after Q2 2020 and in contrast to your peer results. So, wondering what kind of increased spend per visit did you notice that you have been calling out over the past few months? And any metrics that you can direct to between point of care or reference labs that helps us understand this performance? Thank you.

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

A

Sure. I'll start with your diagnostics and then I will let Wetteny sort of do the Draxxin livestock question. As you look at – we're about flat in the first half of the year in diagnostics. And as Wetteny mentioned in his remarks, as you saw the decline, really, there was growth in international. We made a huge investment in creating a stand-alone diagnostics field force and technical team and service team in the US that is highly disruptive as you know if you watched other companies do this over time. But we do believe in the absolute strength of this business long-term, investing in it long-term. As you've seen, we've invested in innovation in our IMAGYST platform, etcetera, to grow this business.

So obviously, as people get into new territories, etcetera, there's obviously some disruption that happens there. This, honestly, was anticipated. We remain extremely optimistic in the growth of this business and the strength of it. We certainly look at the strength of our international business and how well that's been doing and growing that with customers. We're invested in diagnostics for the long-term and really believe we can drive strong growth here. And diagnostics as a sector grows faster than the overall animal health space, and we believe we can bring disruptive innovation to the space to help us drive that. But I'll let Wetteny take the follow-up question on livestock and Draxxin.

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

A

Yeah, sure. If you look at Draxxin, right, it's the largest product that we have across our livestock portfolio. Beyond that, there isn't any other product that's even nearly that size and magnitude if you look across our portfolio clearly, as well in companion animal there are no products that are anywhere near any sort of LOE. So, we would not anticipate after the first two years that the generic competition on it will be the key driver here in the business. We said we expect livestock to be returning back to sort of normalized growth in the 2023-2024 timeframe is what we would expect in that regard from a generics standpoint.

Operator: Our next question is from Chris Schott of JPMorgan.

Ekaterina V. Knyazkova
Analyst, JPMorgan Securities LLC

Q

Hi. This is Ekaterina on for Chris from JPMorgan. Thank you so much for taking our questions. And my question is on the macroeconomic environment here, are you seeing any notable differences when it comes to pet owner demand across geographies? So, Europe appears to be getting hit harder with some of the challenges related to fuel costs and food prices and stuff like that and was wondering if you're starting to see any changes in behavior in that market. Thank you.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

A

Sure. Thanks, Katerina (sic) [Ekaterina]. Good to have you on the call today. If you look at the sort of macroeconomics, we continue to see on a global basis very strong demand, and I think what's driving that for us is the innovation that we bring to the market as well as who's adopting some of these dogs, millennials, Gen Z who are more willing to spend more on their pets as well as more of the pets being adopted by high-income families. That being said, Katerina (sic) [Ekaterina], as you double-click into individual markets, you are seeing as economies get affected, obviously, overall demand may go down. But we have so far not seen it in our products. We are monitoring it carefully. I think the one place where we're starting to see a little bit more of that might be Latin America just given some of the really hyper inflationary markets that you're starting to see there.

But what we've really been pleased about in companion animal is the continued strength and willingness to spend and investing in innovation-disruptive technology. So, there are certainly differences as you get into individual markets across the globe, but overall continued strong demand. And I would double-click for you since you asked the global question in a few places. One, in Brazil where we only printed about 1% growth in Q2 overall, companion animal still grew 35% in the quarter. And you look at China where we only had 3% growth, companion animal grew 24%. So, even in what many people might consider emerging markets, we're still seeing incredibly strong demand for our products and for our innovation.

Operator: And this does conclude our question-and-answer session for today. I'd be happy to return the call to our hosts for any concluding remarks.

Kristin C. Peck

Chief Executive Officer & Director, Zoetis, Inc.

Great. Look, thank you, everyone, for your questions and for your continued interest in Zoetis. Just to summarize, we see continued strength across our diverse global portfolio, especially in our companion animal and pet care products. We're continuing to invest in talent, in innovation, and manufacturing expansion that can support our future growth. And we're updating and narrowing our full year guidance to reflect a positive outlook for the remainder of 2022 and obviously, as many other companies, the negative impact of recent changes to foreign exchange rates. So, I look forward to keeping you updated on future calls. Thanks so much. Have a great day.

Operator: This does conclude the Zoetis Q2 2022 Earnings Conference. You may now disconnect your lines. And everyone, have a great day.