Corrected Transcript

20-Aug-2019

Elanco Animal Health, Inc. (ELAN)

Acquisition of Bayer's Animal Health Business by Elanco Animal Health, Inc. Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Jessa, and I will be your conference operator today. At this time, I would like to welcome everyone to the Elanco Investor Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Mr. Jim Greffet, you may begin your conference.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.

Thanks, Jessa. Good morning. Thank you for joining us as we announced an important strategic investment for Elanco. I'm Jim Greffet, the Head of Investor Relations. Joining me are Jeff Simmons, President and Chief Executive Officer; Todd Young, our Chief Financial Officer; Aaron Schacht, Executive Vice President, R&D & Business Development; and Katy Grissom from Investor Relations.

During this conference call, we anticipate making projections and forward-looking statements that are based on management's current expectations, but actual results may differ materially due to various factors. For example, our results may be affected by competitive developments, the timing and success of new product launches, regulatory and legal matters, government actions, change to tax law, and the impact of exchange rate. Also, the proposed acquisition is subject to antitrust clearance which cannot be guaranteed.

For additional information about the factors that affect our business, refer to our forms 10-K and 10-Q. In addition, the information we provide about our products and pipeline is for the benefit of the investment community. It's not intended to be promotional and is not sufficient for prescribing decisions. You can find our press release and the slides referenced on this call on elanco.com.

I'll now turn things over to Jeff.

Jeffrey N. Simmons

President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

Thanks, Jim. Today, we're excited to announce Elanco's acquisition of Bayer Animal Health. Combining Elanco and Bayer Animal Health creates the second largest animal health company in the world based on 2018 global revenues. This acquisition strengthens and accelerates our focused Innovation, Portfolio and Productivity strategy. It doubles our pet business, balances our portfolio mix, expands our pipeline, delivers significant financial benefits, and positions Elanco to capitalize on important trends shaping the industry.

Before we dig into specifics of the deal, I want to level set with you a bit. The decision we're announcing today comes from the intersection of three forces. First, Elanco is a dedicated animal health company executing on a clear strategy and delivering on our commitments. The second force is one where the industry is evolving rapidly. We have very attractive fundamentals, but there are emerging trends particularly in the companion animal space that we must respond to in order to win in the long run. We will describe these trends in more detail during this call. This transaction is a forward-thinking move to capitalize on these trends from a position of strength.

And the third force is we have a very attractive asset in Bayer Animal Health that is actionable now. We don't have the luxury to wait and see. We don't need to do a deal like this to achieve the mid-term goals we've set out. But we are convinced that this is the right move to position Elanco for the long term. Critically, this is not a change in our strategy. We do not intend to take a step backward in any financial performance commitments we've made. We intend to deliver what we've described in our IPO and, in some cases, even more quickly with this transaction.

Let's go to slide 3 and review the highlights. First, our Portfolio. We double the size of our Companion Animal business and create balance across the Companion Animal and Food Animal categories. We also create significant scale for both our Companion and Food Animal business in emerging markets. The mix shift also enhances our ability to capitalize on industry trends. While we've been working towards this shift, this deal is a step change and accelerates progress beyond our current trajectory.

Now, our second pillar, Productivity. With our Productivity agenda, we achieved 60% gross margin and 31% adjusted EBITDA margin faster. Our adjusted EBITDA grows at a double-digit pace, and we maintain mid-single digits sales growth. The deal is accretive to our EPS in the first full year post-close, and will have a high-single digit to low-double digit accretion in year two. This accelerates our financial performance.

Importantly, we'll have strong cash flow generation as a result of this transaction, about $1 billion in operating cash flow in the second year and accelerating, which means we can quickly de-lever from approximately 5 times to less than 3 times by the end of the second full year post-close, largely the same path that we're on now.

From an Innovation standpoint, this expands our pipeline of development projects, while gaining access to attractive technologies and modalities. It also increases our R&D scale and expands our external network to include a negotiated access to Bayer R&D. This is about leadership across all facets of our strategy and positioning Elanco to have the scale and capabilities to deliver value for the long-term to both our customers and shareholders.

Turning to slide 4, let me describe in more detail how this acquisition advances our Innovation, Portfolio and Productivity strategy. We've shown the graphic on this slide throughout our existence as a public company and discussed it on every earnings call. It illustrates our focused approach with the customer in the center, which this deal expands to three key constituents: the veterinarian, the farmer, and now the pet owner. All three of these customer groups are critical, and this transaction expands our value proposition to each of them, particularly the pet owner.

Starting with Portfolio, this establishes our leadership with the pet owner, especially in the fast-growing e-commerce and retail settings where Bayer has industry-leading capabilities. It doubles our Companion Animal sales and nearly triples them outside the U.S., with leading brands like Seresto, a long-acting flea and tick collar, and balances our global sales roughly equally between Companion and Food Animal products. It expands our presence in emerging markets. In key countries like China, it adds valuable brands for cattle and expands our aqua offerings into warm water species.

Innovation benefits as well. We add eight key development projects and more than 30 lifecycle projects. We also gain increased R&D scale which gives us greater degrees of freedom. We bolster our R&D capabilities, add new delivery platforms and technologies and we gain certain access to Bayer's CropScience R&D and de-prioritized clinical pharma assets.

Finally, the move accelerates our Productivity agenda, with a more rapid progression to our gross margin and adjusted EBITDA targets. It delivers strong cash flow to support de-leveraging in the near term, $275 million to $300 million in cost synergies and EPS accretion. We will advance our Productivity agenda by continuing to execute in the same areas where Elanco is focusing today. In the coming slides, we will go through each of these three pillars in more detail.

Moving to slide 5, let's review the transaction specifics. Elanco is purchasing the Animal Health business of Bayer for $7.6 billion. The purchase consideration is comprised of 70% cash and 30% Elanco stock valued at $33.60, Elanco's undisturbed share price, with stock a consideration subject to a 7.5% collar. The cash component is being funded through a combination of debt and equity. We expect to see significant cost synergies, and we expect to close the transaction in mid-2020 once we've obtained antitrust clearances.

Turning to slide 6, let's review the trends shaping this market. The graphic illustrates the favorable dynamics in both the Companion Animal and Food Animal areas of our industry. You may recall this graphic from our IPO roadshow, but it's important to consider the number of trends that have emerged and solidified in just the past year.

In the Companion Animal space, the growing decision-making power and autonomy of the pet owner is driving transformation. Pet owners are becoming much more active in their pets' care, driving remarkable growth of online and retail channels for pet medications. It's about 3 times the rate of the overall animal health market.

Millennials, the first digital generation, are now the largest demographic of pet owners with more than 35% having a pet. We see this very strong trend of younger pet owners with increasing expectations of care spending more through diverse channels, truly establishing a new normal in companion animal health industry.

There's also an increasing pet owner focus on convenience and technological advances in pet care. For example, the significant growth in Bayer's long-acting Seresto collar reflects the broad range of delivery modalities that the companion animal market supports. Adding Bayer's portfolio and established capabilities will give Elanco a closeness with pet owners, as well as the means to leverage this proximity, unmatched in the animal health industry.

Similar positive trends are at play in the Food Animal space. Honing in on the protein supply and demand projections for the coming decades reveals the importance of emerging markets. Having a comprehensive portfolio in these emerging markets will be a key driver of growth. Bayer expands our emerging market presence and adds important cattle brands. This deal is not only a match with our IPP strategy, but it is also forward-looking. It's a forward-looking move as it improves our position to capitalize on where the market is going.

Slide 8 provides a comparison of our two companies. And as we've seen with Elanco and other spin-outs, the dedicated focus we bring to animal health is highly valuable. Let me highlight a few things on this slide that reinforce the rationale for the deal. First, Bayer's 2018 gross margin was 64%, significantly higher than Elanco's. This contributes to the immediate accretion and is additive to our margin expansion goals. We believe there's a real efficiency opportunity in the combined business.

Let's turn to slide 9 and review the impact on our sales, both geographically and across our Companion Animal and Food Animal businesses. You'll see in North America, we grow our revenues from $1.5 billion to $2.2 billion, and increase the Companion Animal portion of our sales to almost 60%. We gain a significant presence in the retail and online pet market.

Internationally, we nearly triple our pet business, with an immediate footprint in China. Also, we gain a strong parasiticide business in Europe and bolster Elanco's Food Animal presence in Japan, Mexico, China and the rest of the world. Worldwide, you can see we're doubling our Companion Animal business from $1 billion to $2 billion, while creating a more balanced portfolio mix. After close, our Companion Animal revenue mix moves from 37% to 46%.

Moving on now to slide 11, we'll provide greater detail on each pillar of our IPP strategy. Elanco has a longstanding relationship with general practice veterinarians. Our acquisition of Aratana added a focus on the specialty vet practice and we've begun efforts, as you know, to build presence in the online space. With Bayer's capabilities launched nearly a decade ago, we will add a leading position in the alternative channels with over-the-counter brands in pet specialty, mass retail and e-commerce.

Critically, it's estimated that one-third of U.S. pet owners don't go to the vet, so these alternative channels are the primary means for obtaining pet medications, especially over-the-counter parasiticides like collars and topicals. In fact, 40% of pet medications in the U.S. are now sold in the fast-growing online and retail channels. Bayer's sophisticated customer engagement capabilities and relationships with e-commerce and physical retailers are best-in-class and would take years to replicate independently.

This acquisition will enable us to serve customers where they choose to shop, while complementing our longstanding focus on the veterinarian. Ultimately, we believe these capabilities and increased knowledge of the pet owner will allow us to better support the veterinarian, serving as a bridge between the pet owner and the vet where the relationships don't exist today.

Slide 12 provides a snapshot of Bayer's business. And as we look across the portfolio, there are key brands driving growth like Seresto, Claro on the companion animal side. In the food animal business, there are a number of high-growth local brands in international markets. These will be the engines that continue to lead revenue growth.

What some may not realize is the extent to which Bayer products resonate with pet owners and farmers. As we look across the Bayer portfolio, there are a number of well-respected and established brands across companion and food animals. We've already talked a bit about R&D pipeline and the significant new product opportunities we see there as well as extensive lifecycle management portfolio.

From a platform perspective, there are strong capabilities that complement our own and will bolster our Companion and Food Animal businesses. There's a lot to like here. Bayer is complementary to our business, they're important growth drivers, and the profile harmonizes with our portfolio approach.

Slide 13 highlights the very large and different parasiticide market segments which our two companies operate today. This market is more than $5 billion in size and growing more than 6%. This slide requires some orientation, but it is helpful in understanding the channels and modalities for parasiticides.

The verticals represent the mode of delivery, on or outside the pet on the left and internal applications on the right. The rows reflect the channel where the products are primarily sold. The top row is outside the vet clinic and the bottom row show products sold mainly in the vet clinic. Elanco's current portfolio is mainly in the lower right quadrant, prescription products delivered orally and sold mainly in the vet clinic. Bayer's portfolio is in the left two quadrants, external medicines available mainly outside the vet clinic with limited presence in the vet clinic.

It shows that when combined, these portfolios are very complementary. They cover all settings and channels where pet owners choose to access medicines for their pets. The combined portfolio gives pet owners more access, choice, and affordability options to treat their pets. Pet owners are increasingly -choose how they want to treat their pet and with the addition of Bayer Animal Health, Elanco is now poised to meet them across every channel.

Now, I would like to specifically address the Advantage Family of parasiticides on slide 14. The Advantage Family is one of the most recognized animal health brands and has a very loyal customer base. The charts on the left side show the progression of U.S. dose volume over the past two and a half years and where losses have occurred. I want you to note two things. First, the most significant declines have come from the vet channel due to Bayer's intentional shift to alternative channels for their parasiticide products. The rate of decline in the vet channel has slowed and represents only 20% of doses sold in the first half of 2019.

Meanwhile, the volume in the alternative channels declined minimally and doses have actually grown in the first half of this year. These channels now account for 80% of the volume. The story international is even more encouraging. We're seeing modest 3% revenue growth in the first half of this year with new launches and important emerging markets like China. We have looked at this closely and have been balanced in our assumptions. Even with the picture we see here, we are appropriately modeling a continued modest decline of this product.

Now, let's move to an important growth driver, Seresto, on slide 15. Seresto launched in 2012 and has shown dramatic growth since then, 23% in 2018, surpassing now $300 million in total revenue. This makes the long-acting collar the second fastest growing product in animal health. There is significant market potential remaining. The addressable opportunity for Seresto is over $2 billion, and one-third of pet owners in North America are still unaware of Seresto. Customers who use Seresto are very loyal. It has a prominent presence on Amazon and new launches still continue, including a 2019 launch in China.

Slide 16 illustrates the extent of Bayer's leadership across the various channels, with number one positions in many geographies, an advanced e-commerce strategy and deep direct-to-consumer expertise. These capabilities will be critical to capitalize on the growing trend of an online shopping in animal health industry, just as we've seen this move disrupt other industries.

As we shift to the Food Animal business on slide 17, the addition of Bayer brings a broad portfolio across a range of health challenges. The left side shows relative sales across the main food animal species, a nicely balanced portfolio augmenting our own presence. Within each species, Bayer has leading positions in a number of different sub-segments and geographies, which expand and diversify our offerings.

For example, in cattle and dairy, strength is in external parasiticides and ketosis control. Swine benefits from injectable antibiotics and coccidiosis control. And in aqua, we now have a more complete portfolio where Elanco plays in cold water species like salmon and Bayer brings products for warm water species like shrimp. Portfolios matter in this business, and having a breadth of products to address the spectrum of farmer needs is a critical element of sustained success.

To conclude the review on the Portfolio, let's look at slide 18. This demonstrates how Bayer augments the Elanco growth products. The 11 products we have launched over the past four years, as well as Entyce and Nocita from the Aratana acquisition, and Coliprotec from Prevtec. This is an exciting area. The bar chart includes the current Elanco growth products that we track each quarter, plus the growth products gained from Bayer, a combined portfolio of 17 different medicines in growth mode. This group shows impressive growth and accounts for more than $600 million in revenue in 2018.

Now, as we segue to the Innovation pillar of our strategy, I want to note that Bayer adds eight key development projects to our pipeline. These innovation opportunities with the potential to launch between 2020 and 2024 span both Companion and Food Animal. They complement Elanco's current pipeline across our species of interest and are focused on novel small molecules or combinations. The combined company will have more than 50 development projects. In addition, Bayer brings more than 30 lifecycle management projects with a potential to advance established products or their derivatives. Lifecycle management projects are an important R&D value driver as they typically have higher probabilities and shorter timelines.

Slide 19 shows how this transaction advances our Innovation efforts. Beyond the projects already in development, this acquisition brings complementary capabilities and longer-term research programs focused in parasitology, companion animal therapy, and ruminants and swine. We gained complementary delivery technologies as well. Bayer has a number of attractive approaches including collars, sterile injection capabilities, and chewable formats.

Additionally, Bayer has more recently announced some very relevant research collaborations and technology partnerships like their collaboration with adivo, a new innovator in the monoclonal antibody arena for animal health that complements Elanco's own efforts to leverage external innovation sources to build a sustainable innovation flow.

Finally, we bolster our R&D scale, giving us greater degrees of freedom to prioritize, accelerate, and invest more heavily in the most promising projects in our combined pipeline.

Let me provide some commentary on Productivity and our Productivity pillar of our strategy before turning things to Todd. Slide 20 highlights how this transaction accelerates our margin improvement. As we've demonstrated with our results in 2019, we are delivering on our Productivity agenda, and the addition of Bayer Animal Health will accelerate and strengthen this delivery. We will add a higher gross margin portfolio, executing on a number of identified cost synergies while improving our operating cash flow. Through this transaction, we expect to achieve adjusted EBITDA margin of 31% in 2022, which is faster than our margin expansion projections as a standalone Elanco. We still intend to deliver 1,000 basis points of improvement doing so one year sooner.

Over the years, Elanco has developed and refined our skills in executing integrations. We have a proven track record of delivering value through synergies. We've identified between $275 million and $300 million of cost synergies that we will capture as we apply our expertise around footprint and SKU optimization, lean manufacturing and other operational efficiency measures. We have the capacity and ability to integrate Bayer while delivering on our IPP strategy and building a standalone fit-for-purpose Elanco.

Slide 22 shows how all elements come together in the combined company. Based on 2018, together, we will be $4.7 billion, number two in our industry, with components in place to continue our projected mid-single-digit sales growth and gross margin expansion. As part of a company solely focused on animal health, Bayer Animal Health will benefit from a singular dedicated focus on animal health, unlocking additional value-creating opportunities.

As we see it today, the components of this growth include: the continued growth of the blockbuster Seresto; growth of the food animal products in emerging markets; desirable pipeline and channel expansion opportunities; and continued stabilization within the Advantage Family.

Todd will now take us through more of the financials.

Todd S. Young

Executive Vice President & Chief Financial Officer, Elanco Animal Health, Inc.

Thanks, Jeff. Moving to slide 23, we have carefully considered the financing for this transaction. While we will be increasing our leverage in the near-term, this slide shows how rapidly we expect to bring the leverage down. The global diversified strength of the combined business will generate enough cash flow for us to bring our leverage below 3 times adjusted EBITDA by the end of 2022. We realized the timing of our deleveraging is different than what we planned at the IPO by approximately two years. But we believe this delay is warranted by the compelling value proposition that our combined focused animal health company creates.

Moving to slide 24, it's important to highlight that strategy must be coupled with execution. We have delivered on our IPP strategy each quarter since our IPO as we've gone about the business of standing up our company, and we will continue to deliver. Our efforts to stand up Elanco as an independent company are tracking as planned and, in some cases, we are ahead of schedule. The timing of this acquisition gives us the opportunity to build the optimal structure for the combined organization.

With the expected close of this transaction in mid-2020, we [indiscernible] (27:20) TSAs, enabling us to smoothly transition our focus to Bayer Animal Health and remain in execution mode. We already have a plan in place to deliberately compartmentalize how we execute this integration and the standup of the independent Elanco while we continue to deliver against our IPP objectives.

We will govern Elanco on three parallel tracks. We will run the company. We will continue to focus on advancing our IPP strategy and margin expansion program, delivering on the commitments we have made. We will also stand up the company. We've made significant progress on our separation from Lilly, which will be largely complete prior to the integration of Bayer. We have a team dedicated to this effort that is insulated and focused on this critical task, and we will integrate. We have the demonstrated expertise and experience to execute an effective, efficient integration, having integrated 10 acquisitions at varying levels, consistently creating value and strengthening our business with each. We will use the same seasoned group of Elanco employees who have done this successfully many times before.

Bayer and Elanco will also use a third-party consulting relationship that Bayer has successfully utilized on previous dispositions. This outsourcing relationship will facilitate business continuity as we finalize our ERP implementation.

I will now turn the call back over to Jeff to wrap up our prepared remarks.

Jeffrey N. Simmons

President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

Thanks, Todd. Let's wrap up on slide 25 and 26, which summarizes what this transaction means for our business. I won't repeat the elements we've shared on this call, but you can see on the slides that all the indicators are positive. This transaction hits on all major drivers of our IPP strategy, and it unlocks value for our shareholders while accelerating our ability to deliver on the financial commitments we made during the IPO.

I would like to leave you with a few key thoughts. First, we have a focused, clear, and effective strategy. Our results thus far convince us that the strategy is the right one and it is working. Also, this deal does not set us back. We continue our mid-single-digit sales growth and expand innovation while accelerating our margin improvements. This transaction advances, strengthens and accelerates our strategy.

Bayer Animal Health is a very attractive asset that is actionable now. This is a move that is forward thinking, made from a position of strength to capitalize on trends driving transformation in this durable, highly attractive industry. Finally, this positions Elanco to deliver longer term value to customers and shareholders.

This concludes our prepared remarks. I'll turn it back to Jim to moderate the Q&A.

Jim Greffet

Head of Investor Relations, Elanco Animal Health, Inc.

Just so we're ready for the question-and-answer session, if you could, ask one question or two at the most, and we'll go through the full list as best we can. Jessa, please facilitate.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from the line of Michael Ryskin from Bank of America Merrill Lynch. Please go ahead.

Michael Ryskin
Analyst, Bank of America Merrill Lynch

Q

Hey. Thanks for taking the question. First, I'll start off with the portfolio. Obviously, you highlighted the presence of Companion Animal and we know that between Advantage and Bayer and Credelio and Trifexis and Seresto, there's a massive number of assets in the companion animal parasiticides. Are you worried at all about any antitrust keeping in mind some things we saw when you acquired Novartis, some of the things that we saw with BI Vetmedica deal, whether there'd be antitrust concerns particularly in that area?

And then, the follow-on is how do you feel getting bigger in that space particularly going into 2020 with the Simparica Trio launch by your competitor? You had talked to headwinds to your own portfolio next year and in 2021. So, how does that factor in given that you're getting a lot bigger in that part of the market?

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.

A

Great. Jeff?

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

A

Yes. Thank you, Michael, for the question. I'll start with the question on antitrust. First of all, with 10 acquisitions in history here, what I would say, first of all, is that we're looking forward to working with the regulatory bodies in the key jurisdictions. We've got experience here. And this is important that we'll work carefully with them.

I think it's important to note a couple things that you know is this industry quite different than maybe others that you've got multiple species, you have multiple therapeutic classes that actually those therapeutic classes continue to grow with many and more products coming in, you've got multiple geographies. And then, I think, lastly is multiple channels, which we've highlighted in one of the slides that we share here in terms of in and outside the vet clinic, in and outside the pet, and then the many different channels.

So, I think that needs to be taken under consideration and we've done that very carefully. And ultimately, the pet owner and the farmer have to win and we believe they do; more options, easier access, more price points. So, those will be the considerations. And we've done – we've taken a very careful consideration in doing this when we assessed [ph] asset. (32:50)

Now, when you look at this space, I kind of come back to the slide 13 that we shared in the deck, you've got a market that you know, Michael, is over $5 billion in size, growing at 6%, innovation has actually expanded. We've talked about the importance of compliance that we still see and part of the driver of compliance is easier access. You've got a third of the U.S. market alone not going to the vet clinic. You've got this channel that is outside the vet clinic and about 40% of the purchases growing at 3 times as fast. Why? A couple things is people want easier access. Today, the biggest demographic in this is the millennials, that's the first generation, I guess, they say in the digital world; and just like anything else and all the other things they buy, access and convenience matters.

So, considering these, we think that innovation matters. We've got a very strong pipeline that Aaron can speak to. We've got great launches going on with Credelio and Interceptor Plus, this would add a Seresto-type product. And then, we've got I think another big part of the innovation with this transaction that opens it up is the access to that pet owner. So, that puts I think hopefully that in a little bit bigger context.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.
A

Jessa, next question?

Operator: Your next question comes from the line of Umer Raffat from Evercore. Please go ahead.

Umer Raffat
Analyst, Evercore ISI
Q

Hi. Thanks so much for taking my question. First, Jeff, just to sort of level set before I jump into a couple other questions. Are you fully committed to the deal even if the [ph] divestiture sum tops (34:25) $300 million revenues? That's my first.

And perhaps a little more specifically, and I know we touched up on this in the last question as well, but could you give us a better sense for whether you've heard any preliminary feedback, whether an over-the-counter advantage does not technically raise an FTC issue with Trifexis and perhaps same on the Drontal side?

And then also, as you talk about the mid-single-digit growth for Bayer Animal Health going forward, can you break that down for the top four products versus the rest of the business? Thank you very much.

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.
A

Yeah. Umer, I want to address your questions as much as I can. I need to be, of course, careful at a high level relative to different product categories and brands specifically on the antitrust side. I want to reiterate again, though, when you look at the fragmentation of the market, the globalization of the market, the number of innovations that have come in, this market is not the same as it was five years ago, it's not the same as it was a year ago when you look at the Chewy.com, Amazon, Walmart coming in. So, I want to emphasize that, as I've said, this is a new normal for companion animal health and I won't speak specifically to different products or brands at this time.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.
A

Next question, Jessa?

Operator: Your next question comes from the line of Erin Wright from Credit Suisse. Please go ahead.

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

Great. Thanks. I guess, can you speak more at a high level to the rationale behind this deal, a deal of such size and magnitude amidst your own transformation as a standalone company, what does this mean as it relates to your originally stated initiatives in terms of stepping up the Innovation with 12 new products over the next five years as you originally stated, and your own cost savings efforts associated with manufacturing, rationalization, and other efficiency initiatives? Are those initiatives still on track and has anything changed as it relates to the strategy for core Elanco here? And can you speak to your ability to accomplish sort of those previously stated top line and margin expansion goals amidst sort of this meaningful integration process?

And then, a follow-up on parasiticides here, can you quantify for us your pro forma exposure to the parasiticide category? I guess, I'm thinking about K9 flea, tick, and heartworm in particular, and how should we be thinking about the competitive dynamics and headwinds as well as the profit trajectory of that product category over time given some of the channel dynamics? And, I guess, how would you – net of those channel dynamics, how would you characterize pro forma organic top line growth for the company? Thanks.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc. A

Go ahead, Jeff.

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc. A

Yes. Thank you, Erin. I really appreciate the question. Let me be very clear. The foundational plan that we have that we launched the IPO on, as Todd mentioned in his comments, is delivering on expectation. We've seen that in the last four quarters. You've seen that in our guidance. We see no change to our foundational plan and feel very good about it.

This, as I mentioned, comes with, one – and really these three forces that have occurred. I really want to emphasize this, Erin, that the first point is we know a dedicated animal health company is faster, is more focused on our industry, and can unlock value, and this IPP strategy is right. That's number one. That's our foundation. That's also force one.

Two is these emerging trends. We like the overall trend, the fundamentals around protein in pets. But these emerging trends that I highlighted around the pet owner, the channels, even emerging markets with African Swine Fever and the importance of protein in emerging markets. So, you put these emerging trends that have emerged a lot in just the last year, and looking at again the vectors of risks and opportunity, we see them very clearly as important to the [indiscernible] (38:16) term to win in a sustained way long term.

And then you add, here comes an actionable asset in Bayer that's available now and won't be available later. And so, when you put these three together, we believe that as I highlighted on my first slide, it strengthens and it accelerates our IPP strategy. It doesn't change it, doesn't deviate it. It's not a move out of weakness or something that is wrong with our foundational plan. We feel very good about our foundational plan. And so, it strengthens and it accelerates that.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc. A

Erin, you'd asked about pro forma exposure to parasiticides. Perhaps one way to think about it is the majority of the companion animal products we're acquiring from Bayer fit into that parasiticide space, not vaccines for example. And we've given fairly good color on existing Elanco in our four categories of products and how our disease prevention breaks down between parasiticides and vaccines. So, you can do some probably reasonable top down math to get that rough exposure.

Jessa, can we take the next question?

Operator: Your next question comes from the line of Chris Schott from JPMorgan. Please go ahead.

Christopher Schott
Analyst, JPMorgan Securities LLC

Q

Great. Thanks very much. First one was just on the 2022 margin targets. What type of cost synergies do you need to realize to get to that 31% margin target? I think the full synergy numbers you gave are by 2025, just trying to get a sense of how much of that do you achieve by 2022 to hit that number.

And the second question was just a bigger picture one. I guess my question is how much focus and investment was going into this Bayer Animal Health business within its parent company, because I believe one of the challenges with the Novartis Animal Health deal was the business maybe wasn't getting the R&D resources it needed and it was kind of late in some product cycles. Is there similar elements of the business here or is this a business that you feel has been funded appropriately and has a pipeline that's staged that can kind of deliver products when they need to be delivered? Thanks so much.

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

A

Thanks, Chris. Maybe, Todd, you'll talk about the synergies in margin, and then we have Aaron Schacht here as well who can talk some of the R&D perspective.

Todd S. Young
Executive Vice President & Chief Financial Officer, Elanco Animal Health, Inc.

A

Yeah, Chris. Thanks for the question. Overall, we do expect to recognize the $275 million to $300 million of synergies over five years. We've not gotten into specifics of how quick that ramp is, but certainly we do expect to get a significant amount in the first couple of years as we look to refine and be efficient in our overall business just like we did on the spinoff from Lilly. Spins do unlock value and the focus on a pure-play animal health company and rightsizing a fit-for-purpose entity we do very much directly in line with our strategy and something that we'll continue to execute on a combined basis.

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

A

Aaron?

Aaron L. Schacht
EVP-Innovation, Regulatory & Business Development, Elanco Animal Health, Inc.

A

Yeah. Thanks, Chris. I think to put in perspective, Bayer Animal Health is about 4% of the overall Bayer business overall. I think if you look at the R&D patterns that we saw, they're investing a little north of 9% of sales into R&D, which is a slightly higher number than we are, but also recognize that depending on scale, the foundational cost of running R&D are going to be the same. And so, investing above that to drive innovation, you probably got to go a little further if you're a little smaller. So that's what we've observed there.

I think they have a nice mix of product opportunities that really reflect the innovation strategy that they've been following for a number of years that produced the A Family, the Seresto collar. They've diversified into some of the more emerging technology areas that become important in the companion animal space. And I think we have great respect for the Bayer R&D team in what they've been able to do. They have built some really compelling brands with some very good active pharmaceutical ingredients. So, we look to sort of add that to what we do and capitalize upon the synergy that comes from that.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.

A

Great. Thanks, Aaron. Next question, please.

Operator: Your next question comes from the line of David Risinger from Morgan Stanley. Please go ahead.

David R. Risinger
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Hi. Thanks very much for taking the question. I have a high level question just about the Bayer embracement of alternate channels and the vet response. You described how the vets decreased their use of some of those Bayer products over time as they push more online et cetera. Can you just talk a little bit more about that and how you think about that balance, particularly since vet prescriptions are required for most animal health products obviously outside of flea and tick, and whether there will be any perception risk to the Elanco Companion Animal franchise? Thank you.

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

A

Thanks, Dave. Just very insightful question, David, and one we've taken very carefully as we've had a long heritage focusing on the veterinarian. We built our Companion Animal and Food Animal businesses around it. We start and end every conversation in animal health by great animal health starts and ends with the veterinarian in the center. That does not change.

And so one of the things that we believe are critical when you look at the number of people and this trend is global that are not engaging with a veterinarian on a regular basis. With cats, for instance, that number is very high. Dogs, it's less. But again, it's at least a third, if not greater, in the United States and it's even greater outside in other markets.

So what we're able to do here, we believe and we've seen Bayer do some of this, but with a dedicated focus and the global footprint of the two companies together is to be able to meet that pet owner where they are, have access, actually be a trusted advisor to these players like Chewy.com and Amazon and Walmart because we've got the portfolio that can go both places in the clinic, in a vet clinic like in a Walmart, as well as in the channel that doesn't require a script. And then being able to have that access and that digital connection with the pet owner, you're able to bridge it to the veterinarian for those health care long term programs that are more comprehensive than parasiticides and take them to the vet clinic for the annual vaccine administration, et cetera. So we feel very good about this.

The vet clinics that are thinking about the future are thinking about this as well. And so our goal is to partner, our vet team will be partnering with them to ensure that we can assist and enable with this capability. But this is something we've been very conscious of and aware of. And as you know, we've been in the retail business now for two years, so we've had a good experience with our brands, at least understanding this dynamic and being able to leverage that. And we've doubled our business as we told you between 2017 and 2018, and we think that there's good synergy here if it's done correctly.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc. A

Thanks, Jeff.

David R. Risinger
Analyst, Morgan Stanley & Co. LLC Q

Thank you.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc. A

Couple more callers?

Operator: Your next question comes from the line of Kevin Ellich from Craig-Hallum. Please go ahead.

Kevin Ellich
Analyst, Craig-Hallum Capital Group LLC Q

Good morning. Jeff, wanted to see if you could talk a little bit about the innovation and what's in the pipeline for Bayer. Do they have a triple combo that they've been working on or collaborating with some people? You've talked about adivo on the monoclonal antibodies side. And I think they might have some collaboration with a Japanese company as well. And then, for the omnichannel business that they have, I mean, does this change your view on using distributors going forward and maybe doing more direct business? Thoughts there. Thanks.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc. A

Thanks, Kevin. Maybe we start with Aaron with the pipeline.

Aaron L. Schacht
EVP-Innovation, Regulatory & Business Development, Elanco Animal Health, Inc. A

Sure. Kevin, thank you. First, I think I'll start with what we saw when we got access to understanding what's in Bayer's pipeline was a very complementary approach to ours. First of all, the majority, if not all, of the efforts they have underway fit within our six therapeutic categories that we talked to you about before. So, we're very familiar with what's going on there. And we see most of what they're doing just very complementary to the pipeline we already have that I should just mention is delivering and delivering well.

Relative to specifics about their pipeline, [ph] whether we're going to (46:28) share those details, it's not sort of our opportunity or right to do so at this point in time. But then, you did bring up some of the more recent deals they've signed in terms of adivo or a Japanese CropScience relationship I believe with Mitsui, those factor in to really what I think they've done, is built up their innovation model, an ecosystem that looks very familiar to us. And so, we got to know adivo recently and had our own interest in that company. And now, it seems that we'll have access to that already should this transaction close.

And then in terms of access to CropScience, of course, we understand that CropScience has the best means I think of identifying future insecticides, future pesticides that have relevance potentially in animal health. And so, Bayer CropScience is something we have access to other Japanese companies where innovation occurs readily in this space, the chemistries that happen in this space, we have access to, not just with the relationship that

Bayer brings, but our own relationships as well. So again, we find this as very familiar and complementary and quite excited about bringing this all together.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.
A

Okay. Jeff, on distribution?

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.
A

Yeah. Distribution, as you know, this is very dynamic right now without question. I would just hit a few pillars that are going to be critical as we look at the lens. It's early here. But one is – this is – every time we look at anything in the channel, it's got to be value based. So, it's all about share of voice, the cost to share of voice, the ability for every sales call, the effectiveness and the cost coming back to the value. So, we continue to see relationships with our distributor partners. How we look at that value proposition and how they're looking at it is dynamic and changing, so we'll be looking at that.

The other is considered the widening portfolio. As we have more products across more therapeutic classes, partners help with that and they're able to create share of voice in certain maybe disease categories or product segments that we can't. So, that will be, of course, looked at. It always has been looked at with a value-based approach and portfolio approach.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.
A

Jessa, I think do we have one more question in the queue?

Operator: We do. Your last question comes from the line of Navin Jacob from UBS. Please go ahead.

Navin Jacob
Analyst, UBS Securities LLC
Q

Hi. Thanks for taking the question. Hopefully, you can hear me. I'm on the road. So, a couple of quick questions for you. Number one, what is the magnitude of the total debt raise, please, because it appears that the cash component also has an equity component associated with that, correct? So, there are two components of equity being raised here, right, one that goes to Bayer, it's not a raise I suppose, it's just going to Bayer. But then the other equity component is also used to fund the cash component. Am I understanding that correctly? And then as a corollary to that, if you could help us understand what the total debt amount will be?

And then secondly, I just want to clarify something. On your long term EBITDA margin expectation of 31% that you're now expecting for 2022, I guess previously you'd set 1,000 basis points from 18% to 28% from 2018 to 2023. But now you're saying 21% to 31% from 2018 to 2022. I'm just trying to understand what that change in the starting point for the guidance was and why that is? Was that a function of some of the divestments that you made? I'm assuming it's that, but just some clarity there. Thank you.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.
A

Great, Navin. We can hear you clearly. Todd, those are right up your alley.

Todd S. Young
Executive Vice President & Chief Financial Officer, Elanco Animal Health, Inc.

A

Thanks, Navin. First on the question of how much additional equity will we raise, we'll determine that as we move forward with market conditions. As we've said, assuming a portion of the run rate synergies, we expect to be 5 times levered on an adjusted EBITDA basis at close. That does assume a significant debt raise, but also issuing additional equity. We've not defined those exact ratios yet, but it will certainly be a component of the equity in order to not be more levered than what we've already stated.

With respect to the question of the 1,000 basis points, the 18% to 28% was based on EBIT, while now we're talking about EBITDA, just given the way the rating agencies look at our overall business, we thought moving to the EBITDA standard was appropriate. It's typically been about 300 basis points on the difference between EBIT to EBITDA and so the delta you're speaking to is the 18% to 28% EBIT. You can think about that as a 21% to 31% EBITDA ratio. So, nothing has changed there, just a function of the two deltas on the differentiation.

Jim Greffet
Head of Investor Relations, Elanco Animal Health, Inc.

A

Thanks, Todd. I think we've worked through the question list. We're a little bit before the hour. Jeff, do you have some closing thoughts?

Jeffrey N. Simmons
President, Chief Executive Officer & Director, Elanco Animal Health, Inc.

Yes. I would like to thank you for your time in such short notice here. I would just re-emphasize a couple key points and that is that we feel very strongly that our foundational plan that we launched with the IPO, our IPP plan is working and we're going to continue to stay in execution mode. And that's what we're focusing now with our – even our employees today is the importance of just focusing on that continued delivery and I want you to hear that very clearly.

This is a move that strengthens and then accelerates this strategy as we go forward. And for the medium and long term, taking under consideration these emerging trends that we see as vectors of opportunity and moves that we think are necessary for long-term sustainable value for our shareholders and putting Elanco in more of a leadership position as we combine these two great companies together making the number two animal health company.

I would note too on slides 28 and 29 very importantly that we have made commitments at the IPO. And I would like to just articulate that those commitments as a whole continue. And I wanted to note clearly to our investors the commitments we made and now the commitments that we're making and you can see the majority of all of those commitments are progressions or accelerations to the commitments.

This is not a step back or a step away from anything. It's a continuation of our IPP strategy. It's a continuation of delivering on our commitments and it's been accelerating to do that. And we look forward to working very closely with all of you to communicate the details and the complexity of this as we progress forward, and we'll start to do that starting today. Thanks for your time and look forward to engaging with all of you on a one-on-one basis.

Operator: Thank you. This concludes today's conference call. You may now disconnect.