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# Elanco Animal Health, Inc. (ELAN)

Q4 2019 Earnings Call

## CORPORATE PARTICIPANTS

### Jim Greffet

*Head of Investor Relations, Elanco Animal Health, Inc.*

### Jeffrey N. Simmons

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

### Todd S. Young

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

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## OTHER PARTICIPANTS

### Michael Ryskin

*Analyst, BofA Securities, Inc.*

### Ekaterina V. Knyazkova

*Analyst, JPMorgan Securities LLC*

### Navin Jacob

*Analyst, UBS Securities LLC*

### David R. Risinger

*Analyst, Morgan Stanley & Co. LLC*

### John Kreger

*Analyst, William Blair & Co. LLC*

### Michael DiFiore

*Analyst, Evercore Group LLC*

### David Westenberg

*Analyst, Guggenheim Securities LLC*

### Kathy Miner

*Analyst, Cowen and Company, LLC*

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Ladies and gentlemen, thank you for standing by, and welcome to the Elanco Animal Health, Inc. Q4 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker's presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Jim Greffet, Head of Investor Relations. Thank you. Please go ahead, sir.

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### Jim Greffet

*Head of Investor Relations, Elanco Animal Health, Inc.*

Thanks, Chris. Good morning. Thank you for joining us for Elanco Animal Health's Q4 2019 earnings call. I'm Jim Greffet, Head of Investor Relations. Joining me on today's call are Jeff Simmons, our President and Chief Executive Officer; Todd Young, our Chief Financial Officer; and Katy Grissom from Investor Relations.

During this conference call, we anticipate making projections and forward-looking statements based on our current expectations. Our actual results could differ materially due to a number of factors including those listed on slide 2 and those outlined in our latest forms 10-K and 10-Q filed with the Securities and Exchange Commission.

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 it's not sufficient for prescribing decisions. You can find our press release, the slides referenced on this call, and an investor workbook on [elanco.com](http://elanco.com). The slides and press release also contain

further information about the non-GAAP financial measures that we discuss today during this call. After our prepared remarks, we'll be happy to take your questions.

I'll turn the call over now to Jeff to provide the highlights.

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## Jeffrey N. Simmons

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

Thanks, Jim. Good morning, everyone. This quarter marks the close of our first full year as a public company. We delivered on our strategy, advancing our pipeline, utilizing our portfolio approach to support our customers through unprecedented disease and drought, and furthering our productivity efforts to deliver margin improvement, all while evaluating and integrating strategic acquisitions that we believe will increase Elanco's competitiveness and value for our customers for the long-term. 2019 was an eventful year at Elanco and I want to thank our employees for their resilience and their determination during this exciting time in our company's history.

Let's begin with the highlights for 2019 on slide 3. Our financial results for the year are in line with our previously issued guidance. Full year sales of \$3.071 billion is at the low-end of the sales guidance range, while adjusted diluted earnings per share of \$1.06 is at the midpoint of EPS guidance range. For the full year, Elanco core revenue grew 3% at constant currency and our targeted growth categories grew 7%. We delivered significant improvements in our gross margin, which increased 220 basis points compared to the prior year. Despite incurring a number of new expenses as a result of being a public company, we improved our adjusted EBITDA margin 60 basis points to 21.6%.

We are on track towards our long-term margin goal of 31% for stand-alone Elanco in 2023. We also made tremendous progress building our stand-alone capabilities, which are fit-for-purpose as an independent animal health company. First, we substantially completed two restructuring activities to streamline our commercial, R&D, and manufacturing operations. We also went live on our new HR system, Workday. We have exited 65% of the transition service agreements for Lilly and we have locked the scope of our independent SAP system that we expect to go live in in early 2021. We are on track to stand-up independent Elanco.

Finally, the Bayer Animal Health acquisition is progressing nicely. Thus far in 2020 this year, we received regulatory approval in China, Ukraine, and Turkey. We are gaining increasing clarity on the regulatory front and other jurisdictions and have reached agreements to divest four products, bringing total divested revenue near the \$120 million to \$140 million we expect to divest. Additionally, we've completed all necessary capital markets activities for debt and equity to finance the transaction. Our three-stream approach to run Elanco, stand-up independent Elanco, and integrate Bayer is working.

Now let's take a closer look at our sales performance on slide 4. For those of you that have followed our business since the IPO, you've become accustomed to the quarterly variability across our product categories, and Q4 is no exception. To put this quarter into context, it's helpful to remind ourselves of the results we saw in the comparison period in 2018, which is shown in the first column. I'll let Todd provide the details but you can see that the growth rates in our two Companion Animal categories are largely mirror images across the two years.

We highlighted events that amplified the growth in Disease Prevention in 2018, which now provide difficult comparison, and other events that depress the growth in Therapeutics in 2018, now creating a more favorable comparison. When we adjust for these events, the underlying performance across our categories is on track with our expectations. The 7% growth in our targeted growth categories for full-year 2019 is reflective of the fundamental strength and performance of our business.

The difficult comparison in Companion Animal Disease Prevention belies the strong underlying performance in that category led by Credelio and Interceptor Plus. We recently completed a first-of-its-kind study in collaboration with IDEXX that found 85% of dog parks in 30 major metro areas had at least one dog test positive for internal parasites.

Of the more than 3,000 samples collected by client-owned dogs in the study, one in five had parasites. This finding illustrates two key issues: first, the need for increased pet owner awareness of the exposure to parasites and second, the importance of products that protect their pets from all types of worms.

This study reinforces the value of Interceptor Plus, which is indicated for the five different kinds of internal worms where others are not. And when used in conjunction with Credelio also, it protects against fleas and ticks, giving the broadest coverage available.

The Ruminants & Swine categories also possibly impacted by some comparison events, particularly the initial resolution of manufacturing issues at our sterile injectable supplier in 2019 as well as sales of Posilac inventory.

To summarize, 2019 was a challenging year with a number of external events that emerged throughout the year including African Swine Fever, supply challenges, drought, changing producer use of certain products from policy and trade, and the entrant of a new generic competitor.

Despite these challenges, we grew core sales. We increase margins and continue to build the foundation for long-term value creation. 2019 illustrates the importance of having a portfolio diversifying across species and geographies and having a sole focus on animal health. Elanco is well positioned on all fronts, and we believe we'll be even stronger with the addition of Bayer Animal Health.

Let's move to slide 5 and review how we executed on the three pillars of our strategy in 2019. First, on innovation, our strategy is built on launching with excellence, progressing our internal pipeline and complementing our internal pipeline with external opportunities.

Our new products continue to fuel our growth, increasing 60% year-over-year in 2019. This group contributed over \$400 million in sales and represented 14% of our total sales for the year. You can see the growth trajectory of these products in constant currency on slide 15.

We're also pleased to announce that we met the goal of putting 25 antibiotic alternative programs into development by 2020, a commitment we made at the White House forum on antibiotic stewardship in 2015. But I believe most importantly in the area of innovation, when we combine Elanco with Bayer, we'll have 25 launch equivalents planned to go into the market between 2020 and 2024. This will open the next era of innovation growth for Elanco.

Now on the portfolio. For the year, our targeted growth categories delivered 7% growth and represented about 61% of our total sales. These are attractive market segments, as we've discussed in the past, where our portfolio products address important customer needs. We continue to see outsized growth in physical retail and e-commerce for the US in pets. Although, these alternative channels are smaller than the vet channel, they are growing significantly.

Elanco Parasiticides are growing faster than the overall market in these alternative channels and Galliprant is our second largest product in these channels. Our sales have more than doubled in the alternative channels over the

past two years and we remain very optimistic about the future of expanding our reach in these channels and meeting pet owners where they want to shop.

Now turning to our third pillar, productivity. The continued improvement in our gross margin in 2019 is a result of the comprehensive productivity agenda throughout our company. In 2019, our manufacturing organization delivered \$70 million in cost savings and cost avoidance. Recall about \$65 million in savings was delivered last year in 2018 and the team has all the actions in motion to deliver the expected \$215 million in savings from 2018 to 2020 that we previously shared.

Let me be clear, our productivity roadmap is on track. Remember, that often actions taken in the current period take some time to make their way through the income statement. In 2019, we took actions that we expect will continue to improve profitability in the future and they are: one, we negotiated procurement savings across the value chain. Also, we continue the reduction of contract manufacturers, now at 90 CMOs, down from 100 at the end of 2018. We also ceased operations at Larchwood, Iowa vaccine, and Wusi, China API facilities. And we implemented technical improvements and lean manufacturing principles that drove tighter expense management across several sites.

Beyond manufacturing, we announced the sale of our Aqua research and development facility in Canada and Elanco will shift this important capability into other existing R&D facilities. Finally, we continue to make great progress in standing up the independent Elanco as I mentioned earlier. Overall, our productivity agenda is delivering and we're pleased with the progress achieved in 2019.

As I indicated in our 2020 guidance call, we are in an attractive industry. Elanco is moving with speed and agility. Our growth is durable and resilient. And the Bayer transaction, holistically, considering all aspects of the deal, continues to track above our expectations.

Now, I'll turn the call over to Todd to provide more color on our Q4 results and financial guidance for 2020.

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## Todd S. Young

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

Thanks, Jeff. Slide 6 summarizes our presentation of GAAP results, while slide 7 describes the items considered in the adjusted financials. Slide 16 to 21, in the appendix, provides a summary of the adjustments made to the GAAP results to arrive at our adjusted presentation. I'll focus my comments on our adjusted measures to provide insights into the underlying trends in our business. So please refer to today's earnings press release or a detailed description of the year-on-year changes in our fourth quarter GAAP results.

Looking at the adjusted measures on slide 8, you'll see total Elanco revenue decreased 2% in the quarter. On a constant currency basis, total Elanco revenue decreased 1% while core Elanco revenue increased 1% at constant currency. Gross margin as a percent of revenue was 47.9%, a decline compared to the fourth quarter of last year driven by product mix and foreign exchange headwinds in Q4 2019, which are largely offset by continued productivity gains and positive price.

As we have indicated, our long-term margin expansion will be driven primarily by the benefits of cost facing productivity measures and price increases. We expect product mix will not be a significant driver of margin over time, although mix may impact margin in given periods as we see in Q4.

Our year-to-date gross margin is 52.1%, a 220-basis-point improvement over 2018. This improvement is driven by our continued productivity agenda and positive price, partially offset by mix. Operating expense increased 3% in

the fourth quarter. Marketing, selling, and administrative expense was a \$186 million, flat with the prior year, resulting from additional costs from acquired businesses in the current year, primarily Aratana, and incremental expenses as a result of operating as a public company, offset by strong expense management throughout the organization.

R&D expense increased 10% to \$67 million, or 9% of revenue, reflecting additional costs from acquired businesses in the current year including Aratana and Prevtex. Investments in the expanded pipeline have increased costs from R&D infrastructure investments. Operating income decline 12% reflecting the impact of sales, gross margin, and operating expense results I just described. Full-year operating income increased 4%.

At the bottom line, Q4 adjusted net income decreased 17% to \$87.8 million and the Q4 effective tax rate is 11.1%. For the full year, our adjusted EBITDA margin improved 60 basis points to 21.6%, reflecting the execution on our productivity agenda even with the numerous revenue headwinds and the additional expenses resulting from acquisitions and operating as independent company.

Moving to slide 9, let's take a look at the effect of price, rate, and volume on revenue growth. The effect of foreign exchange rates on core revenue was a 1% headwind overall, price grew 2% while volume declined 1%. On the slide, you can see the breakdown of revenue across our four categories. I will focus on constant currency growth, starting with Companion Animal Disease Prevention, which includes parasiticides and vaccines.

Revenue in this category declined 14% in the quarter, 13% from volume and 1% from price. Recall that there were several factors in the prior year that create a challenging comparison in this category. In Q4 2018, we saw stocking of vaccines from new customer agreements. We sold the remaining inventory of Parastar and we saw increased customer purchases of disease prevention products to achieve desired incentive levels across all of Companion Animal since the supply of Galliprant was constrained. The current year decline was driven by these comparison period issues as well as continued declines in older generation parasiticides, partially offset by continued uptake in growth of Interceptor Plus and Credelio. As Jeff indicated, these products continue to perform well with strong underlying demand at the clinic level.

Moving to Companion Animal Therapeutics, revenue increased 34% in the quarter, 27% from volume and 7% from price. The growth is driven by the continued uptake of Galliprant and a favorable comparison from the prior year due to Galliprant backorders in 2018, as well as the additional sales for Entyce and Nocita from Aratana.

Turning to our Food Animal portfolio and Future Protein & Health, revenue grew 2% in the quarter, 3% from price offset by a 1% decline in volume. Growth in this category was driven by the continued uptake of our Aqua portfolio, poultry vaccines and Nutritional products, partially offset by the impact from changing policies in Asia as well as producer rotation.

Ruminants & Swine revenue increased 3% in the quarter driven by a 2% increase in volume and a 1% increase in price. The growth is primarily driven by the sales of Posilac inventory and partial resumption of sales for a sterile injectable product, which had been suspended due to quality issues of the contract manufacturer. Growth was partially offset by the continued impact of African Swine Fever in Asia, changing US producers use of Paylean, and to a lesser extent, decreased Rumensin sales. Note that for the sterile injectables, the supplier is now refilling the supply chain for the various products. We expect the supply chain to be replenished during Q1 and into Q2 of 2020.

Revenue from Strategic Exits decreased 54% in the quarter. Recall that there are only two activities in this category, the contract manufacturing for BI and the production of human growth hormone for Lilly.

Slide 10 provides more details on our overall performance in the US and internationally. Our international business grew core revenue 5% in the quarter while the US business declined 3%, primarily driven by the results I discussed earlier in the Companion Animal Disease Prevention category.

Now turning to our financial guidance for the full year 2020 on slide 11, which is unchanged from the original guidance we provided on January 10 of 2020. As we did initially, the guidance is for the standalone Elanco. It does not include any revenue or expenses from Bayer Animal Health. It includes full year revenues for all Elanco products, including announced divestitures or other products that may be divested, and it does not consider any of the financing elements of the Bayer transaction such as additional shares issued or interest expense from additional debt. It does include the costs associated with standing up Elanco and integration planning for the Bayer acquisition, consistent with our 2019 results. We will provide updated 2020 guidance for the combined company after the transaction closes.

For 2020. We expect total revenue between \$3.05 billion and \$3.11 billion. Excluding Strategic Exits, we project core revenue of \$3 billion to \$3.06 billion. We expect Strategic Exit revenue to continue to decline year-on-year. GAAP earnings per share are projected to be \$0.04 to \$0.16, while adjusted EPS are expected to be \$1.09 to \$1.16.

Slide 11 also shows the foreign exchange rates used for our top 5 international currencies. These rates constitute approximately \$25 million of revenue headwind compared to 2019. Note that the US dollar has continued to strengthen compared to these rates. This guidance reflects the continued execution of our productivity and margin improvement strategy throughout our operations with constant currency, adjusted EPS growing at a faster rate than sales.

Turning to slide 12, you can see the items removed from GAAP EPS to arrive at our adjusted EPS guidance. For reference, we have included in the appendix a walk forward of our estimated share count considering the common shares and tangible equity units issued in January, as well as the shares to be issued to Bayer at close. Again, our current guidance does not reflect the impact of these transaction-related items. Let me turn things back to Jeff to summarize.

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## Jeffrey N. Simmons

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

Thanks, Todd. Let me first take a moment to comment on the coronavirus. Our number one focus is our employees and we're thankful that all of our employees are healthy and safe. We've not seen a material impact to our business at this point but the situation remains fluid and it transcends our industry. Recall that China is approximately 2% of our total sales. We are monitoring several key areas.

First, restrictions on travel and in-person sales rep interactions with customers. We are leveraging virtual and online approaches to maintain dialog. Second, local logistics and the ability to move products throughout China. To this point, we've not seen a material impact on this front. And third, we'll be watching the flow of product into and out of China. We have regional manufacturing operations in China and we utilize several China-based contract manufacturers. Our product flows into the market have not been interrupted in any significant way. As we have safety stock throughout our supply chain, that enables us to minimize impacts from short-term supply disruptions. Again, we're monitoring the situation closely and we will update the assessment for our business as appropriate.

In closing, we take stock of 2020 and beyond. There are many things that excite us about Elanco's position right now in this durable industry. First, our new products are performing well and bring momentum into this year. They are early in their lifecycles. We are investing in them, and they continue to be important drivers of growth. Second, as we've previously shared, we plan on launching new products in 2020, such as Experior, a new feed additive for cattle; a novel interleukin-10 product for poultry that can be used in no antibiotic ever production approaches where there is significant unmet need. And we continue the geographic and label expansion of products like Galliprant and Credelio.

And we have a robust pipeline, as I've mentioned, including 25 potential launch equivalents for the combined new company throughout 2024. Our margin expansion efforts are increasing our profitability with continued improvement ahead of us. The fundamentals of our industry are also favorable with persistent demand for animal protein and a dynamic Companion Animal sector. And we're progressing to a mid-year close on Bayer Animal Health acquisition. We believe the combined company will be positioned for leadership in all the channels that matter, to farmers, veterinarians, and pet owners.

With all of these elements that I just mentioned, I believe that Elanco stands as one of the companies with the most potential to create value for our customers, society, shareholders, and other stakeholders.

Now, I'll turn it over to Jim to moderate the Q&A.

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### Jim Greffet

*Head of Investor Relations, Elanco Animal Health, Inc.*

Thanks, Jeff. We'd like to take questions from as many people as possible, so try to limit your questions to two or a single question with two parts. Chris, can you please give instructions and take the first question?

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## QUESTION AND ANSWER SECTION

**Operator:** [Operator Instructions] Your first question comes from Michael Ryskin of Bank of America. Your line is open.

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### Michael Ryskin

*Analyst, BofA Securities, Inc.*

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Great. Thanks for taking the question, guys. I want to start on the Bayer transaction. You've made a number of comments in the last couple of weeks and reiterate that says that it's tracking above expectations, things are going well with the underlying business, the performance, the conversation with regulators, et cetera.

Could you really go in a little bit deeper in that in terms of how much better it's looking than you expected, what it is that's getting you really excited relative to the initial plan you laid out for us in August of last year? So, what have you seen in the feedback from channel, from customers, what have you seen as you've gone deeper and now that it's been about six months since that initial announcement? And then I've got a follow up.

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### Jeffrey N. Simmons

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

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Sure, Michael. This is Jeff. Thank you for the question. Yes. So, as I shared at the conferences and also with the guidance call, to be very clear, I'm going to look at this holistically across many streams of this transaction. And

we've looked at this transaction in many streams with many options, many levers to achieve the value that we need to for our shareholders and for our customers. So, if I just take each one of these I'll just highlight.

First, Bayer will announce their earnings next week on the 27th, I believe, of February. But as we look at their performance in 2019 relative to our due diligence assumptions and findings, we feel very good about that being validated with this year's performance by Bayer. I also think secondly, as you look at the trends as we just mentioned, and you look at alternative channels, we feel very good also that a lot's changed even since August. When you look at the channel, when you look at distribution and look at it beyond just parasiticides in the US but look at it globally. And we look at launches like Seresto and Advantage and the capabilities that can come to Asia, we see those trends actually emerging more positively than even what maybe we had assumed from [ph] our seat (28:21) in August. So that's another factor that I think we look at.

I think the other is the vet's response. I think you know you can't do this one by one but we've been very diligent looking at this relative to we believe this is an and not an or, it starts and ends with a veterinarian. The veterinarian is absolutely vital to our business and it will be even as vital or more vital as we go forward and it's our job to enable them to not only be successful in the clinic but be successful in reaching a lot of pet owners that are either not coming into their clinic or that they're not compliant, not using the products appropriately. So when we model this, when we look at it and when we communicate with the vets, we feel very good.

Then I think the other pieces are pretty obvious. The financing that's occurred so far, the reaction to the financing we have of both the equity and the debt details the – we believe the reaction to this is also a very positive signal to the story and to the strategic nature and the value proposition that we give in the marketplace that was very favorable relative to what we wanted in our expectations. And then I think on antitrust and I'll just close by saying that we've have deals in place for four key assets that we've announced. There'll be a couple remaining that will be more regional in nature. And those will follow here shortly but it's \$120 million to \$140 million of total revenue on the combined company. We continue to feel very good that we're coming up on that number, which means that we're coming to the close of what we believe is key. Clearances on countries that are key like China are emerging well and so we're on track.

And then lastly just the stand-up, the stand-up is going well. Remember that even with antitrust clearances, we won't close on this asset until midyear even if we have antitrust clearances because we need to have the TCS system set up and we move it over to Tata as we've mentioned. So putting all that in place, I feel very good while the company is running three streams very well. We're running the company, we're delivering results, and we're making great progress on our stand-up as an independent company with Lilly.

So long answer but I know a lot of people have an interest in this. Holistically, we feel very good, better than we did originally with our expectations.

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**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

Mike, you said you had a follow up.

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**Michael Ryskin**

*Analyst, BofA Securities, Inc.*

Yeah. Great. I appreciate all that color, Jeff. Second question is on another topic that we've got. Obviously, a lot of focus on as the Simparica Trio launch that's expected later, 1Q or 2Q, probably the biggest event we've talked about in animal health for the last several months. What are your expectations for how to respond to this? How do you prepare for it? I mean you talked a lot about the strengths in Credelio and Interceptor and you mentioned that

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the dog park study you conducted with IDEXX. Sort of what are the conversations you're having with vets ahead of that? Have you taken any proactive steps in terms of pricing or any work with your distributors to ensure that you're well saturated into the market, let's put it that way, before the competing product comes in, sort of could you lay out the roadmap here?

**Jeffrey N. Simmons**

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

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Yeah, Michael, thank you. And you know we've had a lot of discussions. I'll talk about our game plan primarily, right. So, no surprise here relative to our expectations when we were launching this IPO in late 2017 2018, we'd highlighted very clearly that there would be likely an entry to the market [ph] before and before us (32:01). We look at this holistically, we look at the parasiticide market one globally, two holistically across all channels. We look at all the different segments. I think that any time innovation comes in, the market has a tendency to expand because innovation creates expansion in markets better ease of use for customers and so I think we keep our eyes first on the whole market and not one sliver in one country.

Now, within that, I cannot emphasize enough that we feel very good about our premium position today with the portfolio we have. I always start with Credelio and Interceptor Plus but when you look at what we have across our portfolio even products like Trifexis and what that does with people that are worried about fleas and the different segments and what we're doing with the channel, we believe our position has never been stronger holistically when you compare ourselves to our position in 2018 or 2017. Now, when I look at again, I think it's important the study that we rolled out at VMX and we're rolling out in the marketplace to really emphasize that with us and IDEXX, the study has never really been done like this, it's a first of its kind, 30 metro areas. You know it's creating awareness of parasites, it's creating awareness of all five worms that matter.

And one in five dogs having that concern or having their presence, that's a big deal. That's been a big launch for us in the marketplace and today Interceptor Plus is the primary product that can do that. Our focus is going to be heavily around we're not going to allow pet owners to move to less coverage as they go forward and that will be our main interaction with veterinarians.

So, like our strategy, like our portfolio and we like our pipeline, Michael. As we go forward, this is – you're going to see a string of innovation from us in this space as we go forward and that string of innovation is going to move both across coverage, new innovation, but also the ability to move channels. And as I said, when you put Bayer and Elanco together, we'll have more exciting stuff going on in this space than we have ever had in the history of our both combined companies.

So, that's – I like our strategy, I like our portfolio and I like our future and pipeline as well.

**Michael Ryskin**

*Analyst, BofA Securities, Inc.*

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Thanks. I'll get back in the queue.

**Jeffrey N. Simmons**

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

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Thanks, Mike. Chris, can we take the next question?

**Operator:** Your next question comes from Chris Schott of JPMorgan. Your line is open.

**Ekaterina V. Knyazkova**

*Analyst, JPMorgan Securities LLC*



Hi. This is actually Ekaterina on for Chris. Thank you for taking our questions. So, the first question is can you provide a little bit more color on the quarterly gaining of gross margins in 2020? Is the gross margin progression we saw in 2019, a decent way to think about 2020 or should we think about more consistent margins quarter-to-quarter?

And then my second question is on Galliprant. Can you just help frame the potential size of the product? Where are we in terms of the penetration for Canine OA? And is there potentially somewhere down the line an opportunity for cats for the product? Thank you.

**Todd S. Young**

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



Ekaterina, thank you for your question. With respect to gross margin in 2020, our quarterly phasing is generally consistent as you can see from this year where the Companion Animal business on the parasiticide seasons is usually late Q1 into Q2 where then in Q4 you see the growth in our international Future Protein & Health category. And so with that, you have the margin movements over the course of the quarter. So, yeah, we still feel confident in this gross margin expansion that we've laid out for investors, including 1,000 basis points over five years with the generally being linear, much like we saw this year with the 220 basis points. We're expecting, again, growth in gross margin in 2020. But I think from a phasing perspective, this year's phasing is a reasonable assumption for 2020.

**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*



Jeff, you want to talk about Galliprant?

**Jeffrey N. Simmons**

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



Yeah. So look, I'll start again with the pain market. I mean, we have definitely very special product here in Galliprant. It's grown significantly every year that we've had it and that's been part of our strategy. And as you look at moving forward, there's no question that lifecycle management is one of the elements to grow this market. Cats is one of those as well as just looking at ease of use, looking at expansion of geography would be another one beyond lifecycle management.

I think the big one though is – and our team here in the US and we're doing it in Europe as well is we have a program called COAST, which is actually just increasing awareness from pet owners on the understanding of a dog coming on with an early onset of OA, and that's important. And about 1 out of 6 dogs has OA but just like parasiticides, compliance and actually diagnosis is absolutely key. And there will be devices down the road that we believe and other mechanisms to actually increase the diagnosis of OA.

And then I would say that moving this to more of a first line treatment versus second line is another priority that we have, as we see that this is a very safe, the safest product in this segment to use. So first line treatment is maybe one of the biggest ones in the short term to continue to increase expansion. I won't define the size. What I will say is we're looking at overall pain. We've got Onsior, which is a product that's come on very nice that's doing extremely well, as well as products that have come from Aratana that we feel very good about as well. Nocita is doing well out of the gate. So again, continuing to work on the whole pain area globally with our entire portfolio. And we see this as one of the more attractive faster-growing segments in the pet side of our business.

**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

Chris, next question?

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**Operator:** Your next question comes from Navin Jacob of UBS. Your line is open.

**Navin Jacob**

*Analyst, UBS Securities LLC*

Hello. Thank you so much for taking my question. Two if I may. Number one, as it relates to Bayer and your diligence that you've been continuing to conduct, I'm wondering if you could provide any kind of color into the pipeline assets, the eight assets that you've highlighted before. What are some of those assets, what are the mechanisms, what areas are they specifically for? Any color would be appreciated.

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And then tied to that, wondering when or what the status of your triplet parasiticide product is? Is that something that could come to the market by the 2021 timeframe? Any color would be appreciated. Thank you.

**Jeffrey N. Simmons**

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

Yeah. Good questions. Let me just highlight. We are in the mode of what we would call integration and Bayer would call separation. With antitrust guidelines, there will be some limitations. So, we entered with our due diligence assumptions. Now, we're working through the stage of integration and separation for them. And there's still clean rooms, there's still some constraints, and I'll be limited on even my access and details to be able to highlight.

A

What we've said is, we like the eight development projects. They're complementary, as you can see, by even our antitrust work, so you can make that conclusion. There's a nice blend between the livestock and the Companion Animal piece. And we believe that they enter into some areas that we're not into at this stage. But that'll be, you know, complementary to us. That's really all I can say.

And then I think as you do the math of the eight development projects and the 36 of the – that we have and you put them together and Aratana's assets, we're really trying to add more color by saying we'll have 25 launch equivalents which are the probabilized candidates in the pipeline and at a robust level of innovation that we'll be launching between this year and 2024, which are these 25 launch equivalents. And in those would be approximately five from Bayer when you probabilize.

So, I'll highlight that. And, you know, within that, there will be a string of innovation in the parasiticide space. Won't give any more color than that than to say that we'll be an innovator in here. And as we've said all along, the intention here is to do three things every time we launch into a market like parasiticides. Add to the portfolio, be first in class or be best in class in some element and we've shown that with our history.

**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

Good. Chris, next question?

A

**Operator:** Your next question comes from David Risinger of Morgan Stanley. Your line is open.

**David R. Risinger**

*Analyst, Morgan Stanley & Co. LLC*

Q

Yes. Thanks very much. So, I have two questions. First, with respect to the gross margin, it was relatively weak in the fourth quarter. If you could remind us about your 2020 gross margin target and your conviction in achieving important gross margin expansion in 2020? And then second, with respect to the DSOs I was just hoping that you could discuss receivables in the fourth quarter of 2019 relative to the third quarter of 2019, and then provide any comment on the prospects for 2020? Thanks very much.

**Todd S. Young**

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

A

Thanks, Dave. Yeah, as noted, obviously, Q4 gross margin was lower. As we look at full year, the 220 basis points is in line with that linear expansion we've been talking about of the 1,000 basis points from 2018 to 2023. As we mentioned, we did deliver \$70 million of productivity savings in the year for manufacturing with the expectation of that full \$215 million we've been talking about since the IPO. That is on track. We fully expect to continue to deliver that in 2020.

As we've also mentioned, mix can be a factor in any given year. We have factored that in as we talked about on the January 10 guidance call. We do notice competitive items like the generic Rumensin as well as the [ph] Triple (42:40). At the same time, we've got a lot of growth coming from our innovative products as shown by the 60% growth year-over-year, and are excited by the continued growth of Credelio and Interceptor Plus with that full coverage for the pet owners as shown by the IDEXX study along with us, as well as what Jeff said, we don't want [ph] pedal re-stepping backwards (43:02), so all of those things that we're confident in as we go into 2020 and that will be accretive on the gross margin side.

With respect to DSOs, again, we've talked here in the last month. Cash flow was disappointing to us in 2019. The accounts receivable is up at the end of the year relative to last year. This was driven by decisions to extend terms in Q3. As we've noted in other forums, we did not extend any terms in Q4, and thus we'll have a very strong cash flow performance in Q1 as we move forward. But overall, we do expect to have better working capital performance in 2020 as it's a big focus for the company this year.

**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

A

Chris, next question?

**Operator:** Your next question comes from John Kreger of William Blair. Your line is open.

**John Kreger**

*Analyst, William Blair & Co. LLC*

Q

Hi. Thanks very much. Jeff, could you just give us your updated thoughts on African Swine Fever and how that is expected to impact the various species and livestock in 2020?

**Jeffrey N. Simmons**

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

A

Yeah. Thanks for the question. I'll emphasize first just a couple of kind of key facts for us just to ground everybody. For us in 2019 for the full year, we landed at the high end of range between \$40 million and \$50 million. We continue to actively monitor the situation on the ground as we're seeing some progress of repopulation

of [indiscernible] (44:43). And the important first step thing, that definitely is of rebuilding the industry and that's tracking to start to see some progress against that and an impact maybe on our business late this year.

Now, we need to overlay the coronavirus and the impact that that may have on this recovery with just the movement of people and the ability to execute on the ground. We'll have to be monitoring that to see if there is any impact. But again, we still see the impact and I want to emphasize this of African Swine Fever, to be largely neutral for us in 2020. There will be a headwind as you can imagine on a like-to-like comparison in the first half. And then, there'll be a slight tailwind in the second half as again, we'll see a favorable comparison.

I think as we step back, I was on the phone and interacting with our Asian team this week, there continues to be cases in some of the ASEAN countries that are emerging in countries like the Philippines, and Thailand and others. So, we're watching this in other regions a little carefully. And then, we're watching the repopulation and trying a little bit closer relative to coronaviruses' impact on the upside. So, that's a little bit of our impact on us in 2019.

How we see it in 2020? Neutral in 2020, negative first half, positive second half. And again, keep monitoring here the repopulation and the emergence of ASF in other countries outside of China. That's where we are.

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**John Kreger**

*Analyst, William Blair & Co. LLC*

**Q**

Very helpful. Thank you. And my second question, I think you said during prepared remarks that your sales through alternative channels have perhaps doubled in the last couple of years. Can you just expand a bit more on what's driving that very good success?

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**Jeffrey N. Simmons**

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

**A**

Yes. So, we've been intentional a couple of years ago in setting up an alternative channel business unit and bringing in some experience. We have some alternative channel products that are OTC-related. But I think most importantly is the people and the partnerships and engaging there and staying very connected to the vet clinic as well and making that connection. And that allows us to not only sell OTC products but also key vet-scripted products that need compliance, easier drop-ship like Galliprant.

So, what I would say is it's a mix of some of our OTC products like Capstar and Cheristin combined with drop-ship needed products like Galliprant, and good partnerships with some of the retailers.

Now, I will say is that will be complemented and there'll be a lot of synergy there as we move towards a Bayer integration midyear. But I would say also just the underlying marketplace growth on e-commerce as an example that is growing as high as three times our industry growth rate and that's just driven by a new consumer that wants to purchase in that area as well as more players in that area, companies that are making it easier more assessable, and that third of pet owners that are not going to the vet clinic at all. Now it's our job, I'll just use this as a chance to emphasize, it's our job and our strategy to use that alternative channel as a way to also channel pet owners back to that vet clinic for, I'll use an example of better vaccines and wellness programs and we believe we'll be a company well positioned to do that and we'll talk more about that as we move into – at day 1 of Bayer.

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**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

**A**

Thanks, John. [ph] Chris, can we take the next question? (48:17)

**Operator:** Your next question comes from Umer Raffat of Evercore. Your line is open.

**Michael DiFiore**

*Analyst, Evercore Group LLC*

Q

Hi, guys. This is Mike DiFiore in for Umer. Thanks so much for taking my question. Just two if I may. Just want to dig in a little bit more into both the coronavirus and Simparica Trio, on Simparica Trio, and Zoetis called a couple of days ago, they really emphasized the importance of being the first to market. Just want to get a sense of how important is being first to market in the anti-parasiticides space, is it like human health where it can be critically important for similar products or is there enough room at the table for everyone? Just trying to understand the commercial dynamics here.

And with respect to coronavirus, just can you give us a sense of how well stocked your supply chain is in case you need to wade out any sudden port closures? I mean does Elanco have an alternative logistics plan in place, and do we know what products potentially have material impact from an Asian raw material supply shortage? Thank you.

**Jeffrey N. Simmons**

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

A

Yeah. Thank you. Let me just highlight on parasiticides. First, I want to back up and say different than human health, animal health is a cash market. It's got a brand loyalty that's a little different. There's not a payer or insurance plan where there's automatic shift in change to a product that might have a slight superiority or a slight difference. Pet owners have a lot of different needs and they're just like different diseases, parasites, as we've shown even with this study, awareness matters as well as just the total market matters.

So to us, what matters is a constant flow of innovation into this space, and ability to move across all channels, and to continually add to the portfolio of innovation, and know your customers and customer segments very well. I think that's very important. So I think it is quite different than human health. First to market is one aspect of many aspects, and I think that you've got to look at these other factors that we've talked about. But moving a dog to less coverage of parasites that we see that are out there that are more prevalent is something that we think is a concern to veterinarians and pet owners, but awareness matters.

So I think there is room. I think it'll expand the market, and that's what innovation does, but there is a lot of brand loyalty as well in this market. So I think the parallels are not as clear and actually are more opportune. And that's what we've seen with the durability of this industry.

Now as I move to coronavirus, this is fluid, this is moving, we're learning every day more about this in the global market. So what I would say is we'll continue to monitor like a lot of other companies. We feel very good where we stand today relative to the size of China, to our CMOs inside and the supplying into China relative to our inventories, relative to the supply situation, we'll continue to monitor that, but at this point in time, we feel that we're in a good position and we don't see any material impact that we see today. But again, that can change as we move going forward. But we feel very good as we sit here today.

**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

A

To add a little bit. Mike, it's Jim. So, we have a business continuity team in a variety of different functions throughout Elanco, including especially supply chain that are looking at this carefully. Of our 90 or so contract

manufacturers, the numbers that are in China, it's in the single digits. There are some there but it's not the majority of the CMO network at all. As we look at both their operations, some are back up and running. Now, we don't know the degree to which they're running at full scale or not. But then, in looking at stashes of inventory raw materials, work in process, and finished goods throughout the supply chain, we don't anticipate that we would have stock outages or customers lacking our product for some period of time even if those CMOs weren't able to supply. We're, of course, focused on getting everything back to normal as soon as we can. But we don't see an acute need in the near-term with things like just-in-time inventory that you might see in some other industries. Hope that helps.

Chris, can we take the next question?

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**Michael DiFiore**

*Analyst, Evercore Group LLC*

Q

Thank you.

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**Operator:** Your next question comes from David Westenberg of Guggenheim Securities. Your line is open.

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**David Westenberg**

*Analyst, Guggenheim Securities LLC*

Q

Hi. Thank you for taking the question. I apologize my call dropped a couple times, so if I missed this. So, I noticed there were some changes in your distribution strategy with small distributors. Is there any contemplation of maybe disruption of distributors in the guidance? And is this kind of a signal of maybe future strategy around distribution?

And then my second question was on Entyce. I'm not sure if you can give me maybe kind of the peak sales but it is a very good product and it finally has the backing of a very large sales force. So, is there any thoughts you can think of [indiscernible] (53:26) market, maybe not quantitative but qualitative? And then is there an additional maybe a leg uplift with Entyce for cats? Thank you.

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**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

A

Dave, thanks for muting as well. So distribution network, Entyce, and then thinking about Entyce for cats.

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**Jeffrey N. Simmons**

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

A

Yeah. From a distribution standpoint, yes, we have and we've been public about this that we have prioritized and cut distribution down to four major distributors, and I'm talking primarily the pet market in the US. Our intention here is to be very focused on value and of course, you get great logistics and service but also value on areas where we want representation, where we want more value added around certain brands. So we have a very targeted approach that we have set up for this year with these key distributors.

What I would say is we'll continue to monitor month to month as we go through the quarter. But a lot of analysis was done in putting this strategy together and we do not see disruption in the year, still yet to be seen as disruption in the quarter. We'll be monitoring this month to month as we look at it. But we feel very good about our distribution strategy. Distributors are key. And again, a very value-based approach as we move forward.

On Entyce, and I'm going to throw Nocita in there as well, two brands that came with Aratana. And what I would tell you as well as the pipeline, I want to just say that both of these Entyce, this market is a market that needs to

be created and is growing. I think that they did a very nice job, Aratana, of creating placements in clinics. Now, it's our job is to expand usage and create movement through the clinic. Early traction is positive but it's too early at this stage. In any kind of a market creation, there's a phase of awareness knowledge at the veterinarian and then passing that through and pulling that through to the pet owner. That process is in place really in two streams right now. One is the stream of our specialty sales force, and then yes, we'll have campaigns through the year with our overall vet clinic sales force as well. And again, Nocita – and I won't give a price or – excuse me, a peak sales on it other than to say this is a product that we like. It's a first-in-class in a new class and in a new market segment that we're creating.

And on Entyce for cats, what I would say is that's progressing nicely in our pipeline. It's moving nicely. It will be coming in that area, and we feel very good about that and we feel very good about Nocita.

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**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

A

Thanks, Dave. Chris, I think we have a few more people in the call and about three minutes to cover them.

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**Operator:** Your next question comes from Kathy Miner of Cowen & Company. Your line is open.

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**Kathy Miner**

*Analyst, Cowen and Company, LLC*

Q

Thank you very much. Two questions. One, could you give us – help quantify the Micotil and the Posilac on how much of a benefit they were in the fourth quarter? And second question is, could you give us your sense of what your market expectation is for some of the livestock species in 2020? Thank you.

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**Jim Greffet**

*Head of Investor Relations, Elanco Animal Health, Inc.*

A

Great. Thanks, Kathy. It's Jim. So, in Micotil and Posilac, I'd say is high-single digits of Micotil. Remember that we had a stock outage in Q4 of 2018. So, we had zero Micotil sales in 2018. We did have Micotil sales initially in Q4 of 2019. Keep in mind that the resolution, the technical things have come into place but that suppliers now re-ramping production, so we'll be reintroducing the rest of the products in Q1 and into Q2 of 2020. So we don't have fully supply yet, but, say, high-single digits.

And then for Posilac sales, it was in the teens, was the amount of sales that we achieved in Q4 there. And those are the two big factors that drive the perhaps surprising positive results in Ruminants & Swine.

And then Jeff, do you want to talk about livestock?

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**Jeffrey N. Simmons**

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

A

Yeah. I think I start at the highest level and say that global protein have been out in the field the last couple of weeks and a lot of the major protein players and visiting with them. And as you see, because a lot of them are public companies with 300 million less pigs, with the continued drive of the Western diet, with more protein and less carbs, and actually a lot of innovation on products to fit diets and I even believe that the alternative protein is just putting more emphasis on protein and the segment overall, the fundamentals are pretty strong globally.

There's pockets of volatility but as we look at overall, I think you're going to see a market [audio gap] (58:23) range on overall protein. When you look and again, I'm looking kind of globally, swine is still rebuilding and a lot of

movement, probably the most activity today is in swine. But I would see that as in 2% to 3%. And then you're seeing poultry being probably the leader in this segment. A couple of points greater than that in the neighbourhood, we've seen kind of segments around 5%. And we see ourselves growing with that market. And then cattle, 3% to 4% overall.

And I think just by region, just to put a little color, I think you're going to see here in North America, the big opportunity is definitely going to be pork and the need for trade and those trade opportunities are opening up. Brazil and Argentina again continue, they're quite on our radar here but just year upon year another year of growth driven by exports and again competitiveness that I see that Brazil and Argentina have. Europe poultry and pork are a lot of domestic demand but also some opportunities especially from Eastern Europe. China is, you know, I think there's a poultry and beef growth still small off a small base and I think we're still, you know, unable to compensate for the pork losses. Interesting data to me is that you're not seeing poultry consumption grow as much as we assumed inside the country of China replacing pork. So I think pork exports that demand is going to be high and the restocking is going to be a high priority.

So that's just the overall, I think should be a very good year for protein, animal protein overall, pardoning any new challenges, diseases, droughts but I think off the base that we had last year, we should see some pretty good stability.

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## Jim Greffet

*Head of Investor Relations, Elanco Animal Health, Inc.*

Thanks Jeff. We're at the top of the hour. I apologize I think there are a few folks that maybe we didn't get to. I want to be respectful of everybody's time that we've consumed the hour. Katy and I are always happy for follow-ups the rest of the day. If you need anything else, we're happy to help. Any quick closing comments Jeff?

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## Jeffrey N. Simmons

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

Yes, very quickly. I mean I want to just emphasize we're now six quarters in as an independent company. Yes, there's been some noise but when you step back it is our hope and our intention with you as investors that we're being clear on a communication, we have met our expectations on the six quarters, we like the fundamentals of our business as well as the industry. And as I look at the key pillars of running the business, our IPP strategy is working. As I look at standing up, we see a more agile, faster more fit-for-purpose and more cost-efficient Elanco as an independent company. And again, tracking very nicely, working very well. And as we look ahead and you look at our pipeline with 25 launch equivalents, when you look at Bayer doing better holistically than we expected, and look at the underpinning of the growth categories in our launching products, the next era of growth is very clear and ahead of us here at Elanco.

So, thank you. Thank you for your patience and the clarity. And our IR team here of Jim and Katy are going to be available for any detailed questions. Thank you for your interest and investment in our company.

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**Operator:** Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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