Heska

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Ian Martin: Hi. My name is Ian Martin, and I'm a member of the J.P. Morgan Healthcare Investment Banking team. Thank you for coming out this morning. It's my pleasure to introduce our next speaker, Kevin Wilson, the CEO of Heska.

Kevin Wilson: Good morning, everybody. We're almost done. I know it's been a long week. Thanks for coming. Thanks for sticking it out with me.

As he said, I'm Kevin Wilson. I'm CEO and president of Heska Corporation. Thanks for joining us.

To start the morning, we don't have a lot of time. I'm just going to jump right in. We won't be covering 2018. We'll do that on our regular schedule. Historic will be the end of February. We won't be covering a discrete 2019.

What we will be covering today that I think will be super-useful to investors and animal health health generally, and investors in Heska specifically, is the global animal healthcare trends that we see, and Heska's position and strategy within that trend.

To start with, I think it'd be useful to cover the different buckets that are coalescing in animal health. You have testing, which reflexes to treatment, primarily pharmaceuticals and vaccines, which reflexes to diet for long-term diet healthcare, which is all recommended and managed by the veterinary healthcare provider.

We see this cycle where you have large balance sheets and large cash flows. Each of these buckets, they're integrating. Part of what makes veterinary healthcare and animal health interesting is the positive regulatory environment.

There are no Star Clause. There are no Sunshine Acts. There are no issues with reflexing and recommending certain pharmaceuticals and vaccines based on certain diagnostics.

Another thing that is interesting about pet healthcare is that diet is long-term healthcare. Diet can

be therapeutic. It can also be prescription. It's all managed by the veterinarian.

Specific to veterinary healthcare, it's been a great place to be. It's been growing five to six percent fairly consistently. There's a trend to humanization of pets that's been covered extensively. That trend is now on a global basis.

These family member pets require the same kind of healthcare for a lifetime, whether it's juvenile, middle age, or geriatric care. They're long-term clients and they're long-term healthcare opportunities, which makes a lot of these stocks and a lot of these businesses historically recession-resistant.

To cover that, I know that's an interesting topic for people recently. We went back to 2000 and took a sampling of three publicly traded companies. Two of these companies are no longer with us. As publicly traded companies, they thrive as companies that have been acquired recently -- VCA by Mars, Abaxis by Zoetis.

You can see from 2000 to 2017, we've obviously had a number of difficult periods from the dot com era, to the 2008 difficulties, to the periods of 2015 and '16. Revenues have held up very nicely for companies in the veterinary healthcare space.

Similarly, you can see that EBITDA during those periods has held up very nicely during those periods. The stocks have performed and been rewarded for this during that period, outperforming most indices that you can find. Veterinary and animal health has been a great place for investors to be.

When you look at long-term multiples, where are we at today? Animal health is trading roughly 23 times of the basket that we've put together. I got the small print down there. I would encourage you to download the presentation if you need the specifics.

Compared to the diagnostic point-of-care basket that we've put together, trading at 20.7 times. Compared to the pharmaceutical index, trading at 14.1 times. What's interesting about this is they're all trading not at highs, but they're all trading closer to medians. They're not at all-time highs today.

How have these stocks performed in difficult periods for pull-backs? You can see 2007 and '08 when veterinary healthcare was maybe not on the radar as much as it is today, the 36-percent performance is roughly in line with what we saw during that difficult period for the pharmaceutical

index that we have.

You can see in the '15 and '16 time period that veterinary and animal health companies have outperformed most of the other indices that we've prepared for you on this slide.

Specific to veterinary diagnostics, which is primarily where Heska operates, we think that diagnostics has been the place to be, and that it's growing at roughly seven to eight percent. It's a major profit center for veterinarians.

Roughly 20 percent of their revenue and their profits come from diagnostics. It's viewed as something that's important to do well.

It's viewed as something that's not a cost center, but it's a profit center. Diagnostic utilization occurs and arises today in roughly 15 percent of hospital visits. We see that trend growing. Roughly five percent growth in hospital visits, we're seeing at the end user. You combine those two, those are both very positive trends.

Diagnostics are favored by veterinarians because it requires licensure. It is secure against online. It's secure against home delivery. It's secure against non-ethical channels. So they favor it. They tend to want to grow that.

New point-of-care technologies that we and others are advancing lead to more tests. They also tend to pull tests point-of-care, where they're instant and immediate. Primarily important because pets can't speak. Diagnostics effectively speak for the pet. If you can get an instant diagnosis, that diagnostics then is important for the next steps.

In terms of just tight budgets and economies, it's important to note too that veterinary spending occurs first in diagnostics. It's secure in terms of budget for the pet owner. More so maybe than treatment and some of the other things.

What you have then is you have beachheads being formed. You have integration and consolidation amongst those beachheads, where testing begets treatment. Treatment recommends long-term diet. Long-term diet then results in what's generally happening in general health for the veterinarian. The veterinarian manages that whole cycle.

Let's just break out some of those buckets. In the testing side, you have primarily point-of-care testing. You have reference lab testing. You have single-use testing. You have imaging

diagnostics. In the treatment side, you have large, multinational pharmaceuticals, vaccines, therapies, and in some cases devices.

On the diet side, you have mass consumer-supermarket-level diet. You have premium-level diet. You have prescription- and therapy-level diet, which is designed to be driven by the diagnostics and the healthcare outcomes.

On the veterinary side, you have hospitals either in big-buck stores, like PetSmarts, or you have stand-alone hospitals. You have trends towards home delivery, telemedicine, and mobile delivery of veterinary healthcare.

Let's break out the testing side. You have primarily reference laboratory. In the United States market for instance and globally, you have IDEXX on the reference lab side. You have Mars acquiring Antech via the VCA acquisition.

You have a smattering of university reference labs and smaller regional labs. IDEXX and Antech represent about 98 percent of the reference lab testing market in the United States.

On the point of care side, you have basically three assets providing service to those customers. You have IDEXX again on the point of care competing with Antech, competing with Abaxis which was recently acquired by Zoetis, and you have Heska.

When you move on to the treatment side of the equation, the idea being that certain diagnostics lead to very specific treatments. You have primarily multinational pharmaceuticals.

You have Zoetis being the largest, Boehringer being the second largest and very close with their acquisition of Merial. One is public, one is private.

You have the usual suspects -- Merck, Bayer. Alanco recently did their spin out. They've acquired Novartis.

That's a sampling. There are others in the treatment side.

On the diet side, again, you have Mars with their Royal Canin investment, selling pet diet. That's a nice diversification for Mars, Nestle, and some other folks where maybe sugar won't be viewed as a long-term health benefit in humans. It's a nice revenue stream that they seemed to be happy with.

Other providers are focusing on organic. Think more like a Whole Foods. They're focusing on things like home preparation and things like that.

You have on the veterinary provider side, the hospital side, you again have Mars Petcare making investments by purchasing VCA hospitals, which came with Antech. Banfield which are hospitals primarily, and PetSmart, BluePearl, Pet Partners.

Below that, primarily in the United States market, you have a number of groups of consolidators that are either doctor-financed, private equity-financed, and what have you, that generally represent anywhere from 30 hospitals to 300 hospitals in terms of consolidation.

You have expansion then from North America moving into AniCura and Linnaeus, which would be Scandinavia and the UK respectively through Mars again. Interestingly, and I don't think it's hit the radar of a number of investors, but in China, you have a situation where that industry is nascent. It's rising very quickly. You have consolidation in hospitals as well.

In the North American side, you have roughly 3,500 corporate hospitals. In China, Hillhouse has acquired roughly 2,000 hospitals with a smattering of other investments from people like Goldman Sachs. You effectively have geographical sandboxes with the same business model being pursued.

When you look at that on a global basis, you can see that test, treat, diet, and hospitals is the same model regardless of where you are on the global trend. There's a convergence of all of those companies trying to expand from their geographies, but also from the beachhead that they happen to represent.

Where does Heska fit in to that? We fit in to the testing diagnostics piece or point-of-care diagnostics, and we fit in to the treatment side. 90 percent of revenues occur in the companion animal segment. Roughly 10 percent of our revenues occur in our vaccines and pharmaceuticals manufacturing segment.

Into that market, we had a very good run. In 2013, we started at roughly $78 million in sales. We grew that to $129 million in sales in '17.

Gross margins improved. Negative operating margins improved. Operating income improved. We were rewarded. The stock price went from a low during that period of roughly $5 to a high of

roughly $115.

We did that focusing on the US market, getting our model proper and scalable by focusing on product, team, cost, model, and narrative. We rolled out that game plan early in 2013, worked that through 2017, and recently then rolled out our next act, which we call Act 2, for 2018 through 2022.

Where that has left us with a starting point is we have a full suite of diagnostics. We cover chemistry, hematology, blood gas, immunodiagnostics, coagulation, digital radiography, ultrasound, and other products in this segment.

The way we go to market and what we did in 2013 and '14 is we committed to converting our business into subscriptions model. Today, over 90 percent of our customers are on long-term subscriptions with initial term of roughly six years. Those tend to have monthly minimums of about $1,100 a month. They have four percent annual price escalators built into them.

Heska maintains ownership of those assets, which allows us to upgrade, extend, and swap out those assets strategically over a long period of time with the goal of retaining the customer for decades, not just one cycle through purchase. That's worked well.

In 2013, we ended the year with 370 subscriptions. Our target for 2018 is roughly 2,370 subscriptions. Importantly, our months under subscription has continued to grow as well. We get longer subscriptions. We also get more renewals that outweigh the month's use under existing customer subscriptions.

That has all led to our foundation for launching into what we call Act 2. We believe we go from $129 million in revenue. We can grow that 68 percent to $216 million in revenue by 2022. Gross margin expansion, operating margin in line with what our peer set has been historically. Operating income up 140 percent. We rolled that out at the beginning of this year. I think it was roughly May.

To do that, we grow products. Everything is about products. Products solve problems for customers. That's how you grow a company. We're launching in Q2 of this year our Element RC, which is a rotor-based chemistry product. Also in Q2, we have an immunodiagnostics product launch. In Q2 of 2020, we have on top a urine and fecal imaging product.

The Element RC rotor-based chemistry is designed primarily for international markets. We think the footprint is very attractive. We think the SKU management is very attractive. Speed, ease of

use is also very attractive for international markets, which tend to have a higher level of first-time users as opposed to people who are on their fifth, sixth, or seventh generation of analyzer.

We think we have some significant competitive advantages. Not the least of which is the ability to run up to 20 tests on our rotor, compared to our competition which runs 14 tests on a rotor. That's important in of itself, but it also reduces the number of SKUs. It also reduces the complications of running based on different panels and different stocking.

The Element I Plus is also scheduled for launch in Q2 of 2019. This is our high-sensitivity, multiplexing immunodiagnostics platform. We have a non-multiplexing immunodiagnostics platform today. This version is lower cost, faster, higher sensitivity.

It's got a wider dynamic range and allows us to multiplex. Quantitative readout and it has the ability then to displace lateral flow in the [inaudible] single-use test, substantially lower test price, and we think better performance.

We've also secured global animal health rights for production protein animal, companion animal, and the ability for us to manufacture the product directly. The assays that are currently in development are T4 and cortisol, which represent about 90 percent of the revenue streams from our current product.

Underdeveloped also are canine heartworm, lyme, anaplasma, and Ehrlichia, which is a four-plex test that's designed to compete with 4Dx from IDEXX, FLEX4 from Zoetis. That represents for those two companies roughly $150 million TAM.

Probably the most exciting product launch that we have on schedule is our urine and fecal product. Urine sedimentation is a product that is out on the market with our competitors now for the last couple of years. What is unique is nobody is serving fecal.

Fecal flotations occur about 30 million times on a manual basis in veterinary hospitals. We think it is one of the largest problems we could solve for our customers. The TAM on that combined analyzer is roughly $400 million per year.

We have the ability then with this technology to identify roundworm, hookworm, tapeworm, fluke worm, Giardia, and a number of other things through imaging and AI technology in addition to urine sedimentation in one analyzer.

Our initial product line back in May was to launch a urine analyzer, a year later to launch a fecal analyzer, and then to launch a combination analyzer. We've since validated the ability for us to put those two analyzers together into one analyzer.

Our production and development plan currently looks like this. Q1 of this year, test supplies and test beds are validated. Q2 of this year, alpha instruments will be available with low-volume test supplies for testing. Q4 of this year, we're into beta instruments and test supplies manufacturing at a large volume in our Des Moines facility. In Q2 of 2020, we have scheduled for commercial launch.

Moving on to international, the other way we get to the numbers for the 2022 number is we expand internationally. Currently, Heska gets roughly zero percent of its revenues outside of North America. We intend to do better than zero.

We have launched a direct presence in Australia. That is now live. The team is established and trained. We target revenues to begin in the first quarter of '19.

In addition to that, we've targeted five region partners for areas where we don't intend to have direct operations. Think areas like the Middle East, Ukraine, certain countries in Eastern Europe, perhaps certain countries in Asia for partners that have local knowledge and the ability to drive that business, but we don't have the scale, logistics, or reach to get there in the next couple of years.

This week, we agreed to acquire a company in France. We think that deal will close in the first quarter. It is a company that manufactures endoscopy equipment for veterinarians, which is an imaging product line that we don't have. We think that product line can be sold successfully in Heska's existing channels.

Probably as importantly, they have 900 existing customers in France, which gives us a beachhead in that market to sell our blood diagnostics solutions to that customer base. It's a small acquisition. They do roughly â‚¬4 million a year in revenues.

We expect it to be neutral EPS this year. We expect it to be accretive thereafter. Strategically, it's important for us because it gets much more quickly into that market with existing relationships.

We intend to grow market share. The metric that we focus on often is our consumables growth. It tends to be highest margin product in our portfolio. Traditionally in the market, those run from

anywhere from 60 to mid-70's in terms of gross margin. We've grown that business at a 15 to 20 percent clip for the several years. We see that continuing.

The way that continues is we continue to see our ability to grow market share and get new single user subscriptions. We also have corporate groups. Remember we have the large corporate consolidators -- Mars and Hillhouse. Below that, you have consolidators of 50 to 300 hospitals. We've done very well in acquiring some of the business from some of those.

As those corporate groups continue to do their own acquisitions and business development, 80 to 90 percent of those new acquisitions of new hospitals then covert over to us for those that we have contracts for.

We've been a share gainer. We started 2014 at roughly three percent point-of-care core lab market share in the United States. We entered this year a little over 10 to 11 percent entering '18. We've been in that gain in share.

We expanded our North American sales team in the second half of 2018 by 25 percent, taking us to 105. We intend to extend -- as I already discussed - the international point of care market as well.

To grow test supplies, we want to focus on utilization as well. New products mean new tests. New tests mean increased utilization. We have over 2,000 subscriptions as you saw live. As you have existing customer bases, we think the uptake and new product launches is quicker than it has been in the past.

We still see underlying five percent hospital visit growth from pet owners, continuing. I'll remind you that roughly 15 percent of those hospital visits result in a diagnostic. There's an uplift in terms of utilization. We see that trend as we launch more tests and as our competitors launch more test, improving as well.

Price, our subscriptions include a four percent annual price escalator. That continues. What's interesting about how our program works, however, is it's not annualized. It's basically month-ized.

Customers who signed a subscription in February, regardless of whether it was in '13, '14, '15, '16, received their four percent escalator in February. The same happens for March, April, May. We get a very nice move lift on that.

Growing products, we've discussed that. When you combine all of those things together, that's what leads us to the confidence in the 15-to-20 percent continuing growth that we've done for the last several years in the key consumables.

To summarize that, we see revenues going up. We see operating income going up. I think we have a good plan to get there.

When you layer that over the general trends of testing and the importance of diagnostics as it layers through the testing reflexing to specific pharmaceuticals and vaccines, reflexing to specific long-term therapy diet, managed by the veterinarian that requires licensure to do so, we think we're well-positioned to benefit from those trends.

I think I nailed the under 25 minutes. I'll leave it at that. Thank you.

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