37TH ANNUAL J.P. MORGAN
HEALTHCARE CONFERENCE
January 7-10, 2019 | Westin St. Francis Hotel San Francisco, California

Heska Q&A

Heska presentation delivered at the 37th Annual J.P. Morgan Healthcare Conference on Thursday, January 10, 2019 at 11:30 AM

Presenter: We have a microphone up here. I can repeat your question, so if anybody has any questions we'll get started. Yes, sir.

Audience Member: Can you discuss the OVP segment and would you expect that to bounce back, and if there's some pretty good cross-sales that OVP's going to turn it around?

Presenter: The question is can we discuss the OVP segment, and when do we expect that to bounce back? It's been a drag. It's been lumpy for sure.

OVP, I actually had a slide in a deck recently but just time constraints -- I pulled it out. I think OVP has normalized, which is a nice way of saying I think some of this stuff has fallen out of bed. It's pretty much all fallen out of bed at this point.

We've shrunk that business. One thing that probably didn't entirely come through on the presentation is, OVP, in our Des Moines, Iowa, facility, we conflate the two concepts, but they're really not the same thing.

The first question is, is how well are we doing in vaccines and pharmaceuticals? We're primarily a vaccine contract manufacturer for others. If Elanco sells more cattle and poultry vaccines, OVP's revenues do well.

Most of those contracts have minimums. When we have light quarters throughout the year and we anticipate step-up events in the fourth quarters, a lot of that is based around contract minimums -- that if we didn't sell it in the first three quarters we have a contract that says we're going to sell it in the fourth quarter.

I think that largely plays out, assuming both parties perform. I think the second part of the question then is at $15 to $20 million in revenue, mid-20s in margin, why are we in the OVP business if 90 percent of our business is in the core companion animal side?

That's where we get into conflating the vaccines and pharmaceuticals business with the Des Moines facility. The Des Moines facility is about 170,000 square feet. It's got large acreage around it, but it's a USDA-regulated facility, and those, they don't grow on trees.

We own one that's effectively fully amortized. No cost basis. We've owned it for a long time.

It's got 125 quality employees. Some of them have been there for decades. Part of our strategy -- you'll notice that the new products that we've recently licensed for core companion animal -- we have the ability to set up manufacturing production lines directly ourselves.

One of the ways we add value to Heska shareholders is to move up that supply chain. When there's a good fit to buy and partner with somebody who manufactures technology on a licensed basis, we will do that, but if we can also be the manufacturing and use our plant overhead to set up production lines for test cartridges and kits and analyzers in a facility that we already own, that's also a good fact.

The other thing about that facility is the core companion animal side has revenues that derive from that facility. The segment is reported as just vaccines and pharmaceuticals, but out of that facility also comes $15 million a year in Tri-Heart preventative that is sold through Merck but reported through the core companion animal business. $10 million of allergy therapeutic is manufactured and flows through the core companion animal business.

All of the analyzers that we receive from around the world, from China, from Vietnam, from all these places, all those analyzers are received, tested, certified, prepared for shipment. Then roughly 60 percent -- maybe a little bit higher -- of our consumables that ship directly to veterinarians are actually picked, packed, and shipped by that team in the Des Moines facility, which also feeds into the margin on the core companion animal side.

Pulling things out of that, for instance -- if low margin, $3 million, $4 million of under 10 percent margin contract manufacturing products fall out of that facility, and you take a temporary plant utilization charge for a half a year to a year while you look to then bring in higher-margin testing manufacturing to soak up that plant utilization, but a sealed opportunity cost problem. Everything costs something.

You have to stop doing something in order to start doing something. We've been in a slow motion, re-tooling of using that asset in the business that we're most interested in, which is our core companion animal business.

I apologize for the long answer. That's why I pulled the slide.

[laughter]

Presenter: Does that help? If there's a follow-up question, that's fine, too.

[pause]

Presenter: No? Yes, sir, no? Yes, ma'am, go.

Audience Member: Sorry. If you could talk about, I really appreciate the helpful slide bringing more to the story. I've heard of new products coming in the 2018, 2020 time frame. Would you walk me through?

Can you help me understand what's incremental to the market versus what is a required shared [inaudible] with a competitor and why you're confident that you'll get some of the share?

Presenter: That's a great question. The primary new modality is the 2020 fecal capability that currently nobody addresses that market. That's a manual process veterinarians around the world would like to do it non-manually.

There have been efforts by other companies to do single-use antigen base type tests to address that problem. We haven't seen those come to market. We think our analyzer base, cartridge based solution automates a manual process. We think we've de-risked to that largely. That's exciting thing for the market in general. That's purely incremental un-addressed.

For Heska, a lot of these other tests are purely incremental as well. Once we move past the T4 and Cortisol on the Element i Plus, when you get into heartworm and 4Dx -- which is about $150 million TAM -- at our competitors, but we're not really on the field in that.

It's not really new to the market. Is it market share. It's 100-percent new to Heska in terms of our ability to compete for some of that market share. It's a combination of both.

Audience Member: Why do you think you'll be successful in terms of gaining market share from your competitors. I understood the incremental for you, but you have to take share from them to be successful?

Presenter: It's a valid question. We think our products are good, we think our subscription model is good. The competitors say we're terrible and vote no every day, so it's a competitive market. There's no question about that, but we think if we deliver a better test at a better price, you've got a pretty good shot.

Audience Member: Are you the only one with a paid subscription model?

Presenter: No. Models are interesting things. They're not proprietary and they can be copied reasonably well. You can put different spins on it. One of the things that drives a difficult transition to a subscription model when you're placing expensive capital equipment is revenue recognition.

What we see with bigger competitors is the desire to protect traditional revenue recognition in the core of their traditional revenue streams, but as they launch new geographies and new products that circle around those traditional recognition streams, we see more subscription-style releases.

For example, a couple years ago when the first year-end sedimentation analyzer came out, that was basically a subscription model around a more traditional model in most markets. It's not binary. We're probably the most binary that we really only do the subscription, and would love to get to 100 percent, but it's not a proprietary thing.

We have large competitors like Zoetis and IDEXX, and they're smart people, and they compete. They will prepare things that at least appear to be subscription -- maybe they are in fact subscription, that's their job, not mine.

Audience Member: Thank you.

Presenter: Another one, yes?

Audience Member: [inaudible] everybody jump in. Could you talk a little bit about the market dynamics you're seeing?

Whether, I know you're [inaudible] perception [inaudible] , but are you seeing anything that whether it's new products, or just demand in general? Whether is there an accelerating tailwind behind you, or do you think it's pretty steady eddie [inaudible] sort of market growth right now [inaudible]?

Presenter: I hope it's steady eddy, because that's a great lift. There just aren't that many places where you get that kind of a tailwind, which brings up an interesting point. These tend to not be zero-sum games. We tend to like UFC cage matches, and who won, but the reality is Abaxis did quite well for a long period of time, while IDEXX it quite well, while VCA did quite well, Zoetis quite well, and we think Heska did quite well.

You can all thrive in a market that's growing seven to eight percent. I applaud some of the work done by our larger competitor on the humanization of pets and some of those demographics, but those are real.

That doesn't feel like marketing to me, we actually see Millennials more attached to their pets. We actually see people spending more on pet healthcare than they do on cable television. We actually see these. These are real trends.

Even with some of the international stuff with China, it wasn't too long ago that you effectively couldn't legally own a pet in China. I don't remember what the statistic is, but I think it's 70 to 80 percent of the companion animal pets in China are under two years old.

They haven't gone through their first healthcare cycle. It's the Wild East not the Wild West. Those are real demographics as well. It's really hard to look around the veterinarian animal healthcare market and find bad trends.

Investors have appreciated that and maybe rewarded the stocks with that. Those trends are real. The data beared out in common sense what you observed beared out.

Audience Member: How did you expand into Europe? Could you just for [inaudible] ?

What is that in Europe? I know you're just starting to expand there? What's the opportunity? Are you seeing signs that could increase?

Presenter: I would love to give you an answer, but mom said, "If you don't know, say you don't know." I don't know.

It is one of the interesting things about Heska and a company of our size. We have the benefit of companies that will have large analytics departments. We actually don't have to spend an awful lot of time researching some of these things directly.

I'll give you an example. If you have a direct competitor pulling $1.4 billion out of the same market that you're competing in and you're pulling 1.130 million, [laughs] you know that the TAM is addressable. It becomes, "Do you solve problems for customers better than they do?"

We think we benefit when a large competitor drives utilization so 15 percent becomes 15.1 percent. We don't think that's brand specific. We think that happens at conferences like this for veterinarians. Every veterinarian who attended that conference that learns how to do more utilization, regardless of their brand, will do so.

That's not a one-for-one. We haven't spent money trying to investigate whether it's higher or lower in Europe. Our sense, we have done some, "What is the level of testing?" Our sense is it's very market-driven.

Germany will behave much more like the United States. Spain will behave more like the United States.

You'll have softer markets in Italy. You'll have softer markets in Czech Republic where they do less testing. Europe is not a monolithic thing. We haven't spent the time to parse it out maybe like some of the bigger competitors have. Yes, sir?

Audience Member: Do you do anything special to keep your customers sticking with you so that the big boys don't come in and cut down your pricing in year one [inaudible] .

Presenter: Yeah, the question's how do we keep our customers sticky and how do we keep the big guys from under-pricing us? There are two really interesting dynamics that I thought were in play when we started this in 2013 and '14.

The word picture I use is a chess board. You can lock down large pieces of a chess board with one piece. You could take a pawn and lock down a major piece simply because it's positioned in the right place. I view pricing as that.

Visually, if you have over 50 percent market share -- say you're a 65-percent market share player -- the relative value of maintaining 240 hospitals in the United States, that's about one point of hospitals compared to taking one percentage point of price discount as opposed to four percentage points of price increase. The relative value when you have 65 percent share is so mathematically irrational that it's very difficult to do.

The challenge I would put back to maybe some of the big boys is, "How do you come in and compete on price without eroding your market-leading margin?" So far, that's played out where none of us have really relied all that heavily on price.

We have a good price benefit. I believe that. We also have a model that's more fair, we think. We think it's a little more transparent. We think our equipment actually is better.

We don't go in, run the numbers, and say, "We're going save you 42 cents a study. Go with us." We're more thoughtful than that. Price is just one component of that.

In terms of keeping them sticky, the subscriptions have been six-year terms for the last several years now. We haven't had breaches. We haven't had folks leave without...

It's like your cell phone contract. If you want to leave AT&T early, but they gave you a phone. You probably got to pay them.

Our program's the same way. Our competitors do the same thing. Our bigger competitors will have contracts that are not terminating early.

Then sometimes you do early buyouts. I switched from AT&T to Verizon. They sent me $150 to pay off the problem. We do it and our competitors do it, where you'll buy somebody out of a commitment.

I like broad picture as the starting part as well. 9 out of 10 customers in the United States still don't have our stuff. That is a different number of fish to shoot at than when 6 out of 10 already have your stuff.

It's a market that's being served by three well-executing companies. They're servicing the needs of the customer. There aren't any veterinarians out in the middle of nowhere who don't know that there are two other options.

They've decided not to go with somebody for the last 10 years for a reason. It's probably a rational reason.

It's not purely math. Like I said, it's not purely a zero-sum game as well.

But we're very sticky with our subscriptions. I did have on the slide we were over 95-percent retention in 2018. Most of our customers will renew and extend their contract with us prior to their end date.

Most of those customers who don't do that will end up auto-renewing because they're happy with the solution. They really don't need the brain damage of switching. Yes, ma'am?

Audience Member: Before Abaxis and VCA had each completed their acquisition, there was some effort to collaborate where one was selling lab services and the other was selling instruments. What's happening now that they've each been bought?

Presenter: The question is, "What are the dynamics between point-of-care and VCA Antech's reference lab now that it's owned by Mars?" It's a great question.

The first thing I would start with is patience. Some of these things take time to resolve. The second point is the enemy of my enemy becomes my friend. [laughs] It depends on how long that happens.

I do think that collaboration between Antech and point-of-care is a benefit. You have to be very careful to make sure it's not too much competition. It's got to be cooperation. That's stalled the investment in that.

My sense is IDEXX is gaining market share against Antech, primarily because they have point-of-care and they have reference lab. My sense is that's probably been more effective in the last year or two. I suspect that Antech will mitigate that and make either partnerships, investments, some kind of ..

It's a competitive market. They'll compete. We haven't seen any announcements. We haven't seen any new contracts. So far, it's been basically status quo. We didn't see huge movement when Abaxis and Antech partnered.

Again, agreements are one thing. Field-level execution with the 97th successful rep in the field working with, it's still about people. We haven't seen that be effective like it is at IDEXX where it's vertically integrated and they control both sides of the equation.

A synthetic relationship is harder to manage when you have two separate ownership sets. You're not always aligned. Sorry for the rambling answer. It's a reasonably complex question.

Audience Member: What did you say was the timing for your launch of your fecal tests?

Presenter: The fecal, we merged with the urine. Now we have a urine and fecal analyzer. We have that scheduled for the second quarter of 2020. It's basically a year from now.

We've been working on it for a while. We're into the second of four or five stages to get to commercial launch.

[pause]

Presenter: Yes, sir. [inaudible] .

Audience Member: You mentioned renewals. Having gone through the process now, would their terms be any different, or what's happening differently?

Presenter: No, the terms have held up. The pricing has held up as well. We haven't seen, "Hey, if I can't pay half, I don't want to renew," type of conversations. We haven't seen material adjustments in the terms. Yes?

Audience Member: Sorry. I was looking at the slides earlier. I thought that next to one of the diagnostic panels that you [inaudible] .

Presenter: No. It's our rudimentary attempt to say if you have five percent increased pet visits and 15 percent of those pet visits are going to result, you're going to get a bump in just underlying, without having to have you pull the calculator out we're saying it's materiality, it's about a point just in underlying more pets seeing more veterinarians. You can move that number higher if 15 percent becomes 15.1 or .2, is probably more likely to move than the 5 percent which we see as more of a long-term demographic trend.

Audience Member: [inaudible] when you're in-house at certain vets -- and maybe I just don't understand the market well enough to ask this properly -- but are you alongside your competitors or is it like if you're a vet, are you a Heska shop, or is it sort of you're side by side with competitors, I just don't know...

Presenter: Almost universally you're one supplier. It's actually been an interesting dynamic. You could launch the world's greatest hematology, but if you don't have a chemistry and a blood gas, and an immunodiagnostics, you probably don't have the ability to reach the customer. Very few customers woke up and say I need hematology today.

They view it as this is blood diagnostics point of care, and this is blood diagnostics reference lab. Interesting enough there, they don't even view blood diagnostics reference lab and point of care as necessarily tied. They do view the number of analyzers on their counter, 98 percent of our chemistry ship with a hematology from us.

I think that's consistent with our competition as well. We tend to look at it like, how do you transition an address, a site? If you have the site you tend to have the site.

Yes, sir?

Audience Member: You mentioned expanding your sales force by 25 percent. How long does it take a sales force to ramp up [inaudible] ?

Presenter: We only give them two quarters. I know I didn't answer your question, but [laughs] .

[off-mic comment]

Presenter: I think our training is very good, I think our story is compelling. Work rate is something that you can't know until you have three months, and then you reevaluate it and manage it closely.

By month four or five you're starting to get a pretty good indication of it. It's either capability or work rate, so we make decisions. There is churn, I think we will all have that challenge. When you're trying to expand, it's a tight economy in terms of just good, talented people out there. They're not everywhere.

We have tended to go younger, they have the energy and they have the work rate, we can do the training. We found that to be effective, I think this crop has probably been younger just on average than some of the others.

We tend to spend less time trying to poach industry folks as opposed to just saying we have a great message, go work. They tend to have a good time doing that, if they're a little more youthful than I.

[off-mic comment]

Presenter: No. I think one of the things that's not on the radar of some folks is there's industry consolidation happening in China at a pace as greater...maybe even greater than what's happening here. In the west, you have Mars, I think would be the dominant acquirer of hospitals and some of these assets. In China, you have Hillhouse through private equity.

They've acquired roughly 2,000 veterinary hospitals in China. Different style, different style of practice, different assets. It's a different market but you have a large, heavy counterbalance building of vertically integrated veterinary healthcare system in China. You have a more dispersed set of assets in the west but I think effectively, they're all headed the same place which is you have to address testing, treating, diet, and healthcare.

Audience Member: Does is make it less attractive for you to have enter because they have too much purchasing power?

Presenter: No. It's not so much purchasing power. Even the western brands and the western style of selling things don't necessarily translate well to the Chinese market. I think that's true actually if you do international business. You can say the same thing for India and other markets. I think we all just have to adjust that.

We're really not focus on that market. If you eat a hotdog at the end and not the middle, so we're still at the beginning of the hotdog. We got plenty to chew on. [laughs]

The bigger guys who have moved into China already I think are getting some fairly standard westernized lessons that they don't necessarily show up plan of flag and people go, "Wow, I'm glad you're here. What would have I done without you?"

It's a hard slug. The point is they're allocating capital to do the same things that we're seeing Mars do on western Europe and United States, and others. That they're a large folks allocating capital in China as well. Eventually, those things converged. I don't know if that's in Europe but that's mergers. It doesn't really matter.

It feels a little bit like cable television and content, Internet providers, and those types of things where you just feel this gravity, pulling things together. Mostly because the customer, the pet owner, or even in the protein side requires these four buckets. They would just assume from one source or two sources as they would get them from six sources. It ultimately comes down to solving the customer's problems.

He reason I pointed out in my presentation the Hillhouse's investment in China is this is a large. It's meaningful, it's consolidated. They're sophisticated, they're well-founded.

Those trends are favorable. We will hopefully someday be competing for those hospitals and hopefully, they'll keep investing. But they might show up in Europe just like Mars showed up in Europe and Scandinavia six months ago.

It can go the other direction as well. I think we're out of time. Thanks, everybody.

[applause]

[off-mic conversation]

[laughter]
