J.P. Morgan 2021 Annual Healthcare Conference

Heska Corporation Conference Presentation

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Corporate Participants

Kevin S. Wilson – Heska Corporation – Chief Executive Officer & President

Christopher T. Schott – JPMorgan Chase & Co., Research Division – Senior Analyst

Presentation

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Good afternoon, everybody. I'm Chris Schott at JPMorgan, and very pleased to be introducing Heska today. From the company, we have the company's President and CEO, Kevin Wilson.

As a reminder, after Kevin's presentation, we're going to have a Q&A session. Anyone who wants to ask a question can do through -- so through the ask-a-question button that we've been seeing at the bottom of the screen.

And with that, let me turn it over to Kevin.

Kevin S. Wilson – Heska Corporation – Chief Executive Officer & President

Thanks, Chris. We're going to pull the presentation up here for you here shortly. Thanks, JPMorgan, for putting the conference on. Just a little bit unusual this year and that it's remote, so what we're going to try to do today is move through the presentation reasonably quickly, hopefully leave enough time for Q&A. Can we queue the presentation? Perfect.

So let's go ahead and advance a couple of slides, I believe, to Slide 4. Back one. Okay. So today, we're going to cover our strategic role in the global veterinary health market. We're going to talk to you about how we plan to double customers in the geographies we serve, double the products and the revenue streams that we serve, and then, of course, we're going to go into our multiyear financial targets. For those of you who did not have the opportunity to review our Investor Day in November, I would encourage you to do so. There will be additional information in that presentation that I think you may find useful.

Okay. Let's advance. Again. So the global animal health and veterinary market. So let's start with the obvious, COVID. COVID has largely been a positive for veterinary providers of health care, but food diet, pharmaceutical, just about everybody has been benefited. We're not in a market that has benefited like Zoom or Netflix, but it has been a substantial tailwind. Numbers such as 15% increases in adoptions are particularly interesting. Most of my peers in the industry appear to agree with me that, that 15% increase in adoptions and other benefits are probably very long-lasting, especially given the fact that dogs tend to live for 12 to 14 years; cats tend to live for 14 to 16 years; and obviously, health care is used more as pets age. So we see a long-term benefit. It's hard to quantify now. I suspect you'll start to see it showing up in the numbers from patient visits and requisitions at reference labs over the next couple of quarters.

Broadly speaking, all of the themes continue to be in place. There is still humanization of pets. There's growth. We're in the diagnostic space, in particular, and diagnostics continues to be a major revenue and a major profit driver for veterinarians, and it's key to veterinary interactions. Diagnostics occur in roughly 15% to 25% of hospital pet visits. And pet visits are part of the $100 a month annual spend, is a rough estimate of what pets are being spent on currently in North America, and about 25% to 30% of that is veterinary health care.

So let's advance to the next slide, please. So all of that rolls into some very positive trends. We see long-term increases in visits. We see long-term increases in diagnostics utilization. Diagnostics, in particular, growing at a very nice rate over the last several years and is anticipated to continue to do so. Okay, advance.

So the environment that we work in, we see veterinary health care as testing, treating, diet and veterinary services providers of medical care. Heska, of course, is in the testing portion of the business. We're in the point-of-care business, single-use testing. Teleradiology is a business that we'll be entering here with today's announcement with the acquisition of Lacuna that is also an e-microscopy, so telecytology. We're in the imaging business, ultrasound, digital radiography, and we partner with central reference labs.

On the treatment side, we believe that diagnostics drives treatment. It drives pharmaceuticals, it drives therapeutics, and it's key to creating the data to justify pharmaceuticals and therapeutics. On the diet side, it's very much the same in veterinary medicine. Diet is considered oftentimes a therapy. It's oftentimes considered a prescription. Whether it's officially prescription or not, but diet is key, and it relies on diagnostics as well to manage what type of diet you're feeding your dog or your cat.

And then, of course, in the veterinary provider side, we have veterinary practices, individual practices, which is still the great majority of the business, and then also corporate consolidators of veterinary practices where we see the diagnostic drives roughly 25% of the care.

Next slide. So to build bridges to those areas of the business, we've recently added Mr. Bob Antin to our Board. He's the founder, former CEO and Chairman of VCA, which was sold to Mars Pet Care over the last couple of years, and he has joined our Board. We think he will be wonderfully helpful in building bridges into the veterinary care side, the diet side of the business and then, of course, just decades of leadership in the industry. So we're excited to welcome Bob to our Board of Directors.

Next slide. And then, of course, yesterday, we announced a very exciting acquisition to our Board of Directors as well. Joachim Hasenmaier, he is a an extremely impressive candidate who has just joined our Board of Directors. He ran Boehringer Ingelheim, which is a privately-owned company, but is generally considered to be the second largest company in the pharmaceuticals and therapeutics side based out of Germany. And he has just a fantastic wealth of knowledge and again, relationships, and we think will help Heska build bridges to the pharmaceutical and therapy side of the business as well.

Next. So for those of you who have followed Heska for long periods of time, you know that we work in 5 to 6 year plans that we call acts. We are currently in the middle of Act Two, where we're building intrinsic value, and we're also building profit value on our way to Act Three, where we hope that we will be the big dog.

So next slide. And what that should look like is we intend to double sales by fiscal end of 2023. We'd be positioned to double sales again in our Act Three. We intend to be at the top of the innovation and value creation chain in terms of R&D and creating new products. We intend to be closest to the veterinarian, which is a coveted position in all of animal health. And we intend to be a leader in must have geographies, such as Germany, core Europe, North America, United States, Australia markets, such as those. And of course, we intend to be profitable, sustainable and rapidly growing through the entire Act Three as well.

Next slide. So to further tighten that up, we've called out 3 initiatives, and they're very simple. We aim in Act Two to double the customers and the geographies that we serve. We have met that goal as of this point in Act Two. To double the product and revenue streams served, we believe we will have met that goal by the middle of this year; and then, of course, to continue to grow in our core business, point-of-care diagnostics, primarily, with consumables growth and growth in imaging and other related products.

Next slide. Again. So on our first initiative, we recently closed last April on the acquisition of scil animal care companies with substantial geographic coverage. We also closed on CVM of Spain. And prior to that, we added Optomed of France. And we put those together, and Heska now has double the customers and double the geographies that we that we cover. We're in 25 markets, and we're growing.

Next slide. And that growth is off of a very strong baseline. So in North America, we believe we have a #3 market share. In core European markets and the spaces that we focus on the most, we believe we have quite good market share, #1 or #2 in several markets that matter the most. We were 500 professionals, 150 direct salespeople that focus on nothing but point-of-care diagnostics and related services of Heska. We have a direct sales team in 10 countries. We have logistics in 7 countries, and we have tens of thousands of analyzers across our portfolio installed in the countries that we're now active in.

Next slide. So you'll see here, in 2018, we began basically as a USA-centric company. If you throw Canada in there, 93% of our revenues were coming from just the United States and Canada. As we conclude 2020, our geographic mix is much more favorable, roughly a 65%, 35% between North America and International. I'll point out that the international hospitals count is actually substantially higher than the North America hospitals count. So for us to be in strong positions to grow from the international markets where we see much greater greenfield opportunity is exciting as well. So our geographic mix and our customer base is substantially expanded, and we like where we're entering 2021.

Next slide. Similarly, our sales mix of our products. So in 2018, you can see that point-of-care imaging was 18%; point-of-care lab at 45%. We have focused very hard to grow those businesses faster than the other businesses that are less of a focus for Heska. So we are attempting to be very close to a pure-play in diagnostics, point-of-care diagnostics, in particular. We are well on our way to doing that. We really like the product mix that we have today, roughly 80% in point-of-care diagnostics; 12% in other core companion animal products. But those include things like allergy diagnostics and allergy therapeutics, businesses that we're excited about as well. So product mix wise, we're in a great place as well as we begin 2021.

Next slide. And of course, we've done that all by creating subscriptions. So we've had fantastic uptake in the subscriptions model in North America, 28% compound annual growth rates. As importantly, we have over 95% subscription retention, so we're thrilled with that. We're thrilled that our customers are thrilled with us. And our subscription values in each of those contracts continues to rise as well. So the team is doing a great job. We're in the early stages of taking this business model into our new European theater, and we are encouraged early results that it will be responded to very similarly.

Next. Again. So to double the products that we offer to a doubled footprint, we will continue to roll out menu expansions and analyzers that we've already launched. Similarly, we will continue to upgrade analyzer platforms that we already have. We'll talk about one of those that we're launching today. We'll continue to in-license brand-new analyzer platforms and menu to be sold in place to our thousands of customers that are already on subscriptions. And then, of course, we intend to continue to invent homegrown Heska innovations so that we can be first-mover advantage in key markets.

Next. Additionally, we'll continue on business development. We had an announcement this morning in that regard. We'll cover a little bit later. But we will continue to add new products and services. We will continue on market consolidation, like what we did with scil and CVM in Spain, what we've done in France and are doing in other markets in terms of putting those businesses together for scale. And of course, we'll pay attention to the strategic and the accretive value. I think shareholders who have followed us for some time will agree that we've been a good steward of the money that we put to work and the investment that we make.

Next. All of which rolls up into a product portfolio that is the freshest in the industry. There are more new badges over the last 12 months on our product portfolio than there are current badges, and the team has just done a fantastic job of rolling out innovations. And innovation create better products. Better products create differentiation, price power and market share opportunities. So expect Heska to continue to roll those product and innovations out, some of which will be on the next several slides.

Next. So in imaging, we continue to innovate, primarily in ultrasound and digital radiography. A comment on 2020, we anticipated that COVID would hit the imaging business, maybe a little bit more than it has. The imaging business tends to be more capital equipment-driven, meaning the transaction sizes are between $25,000 and $50,000 in that range. And they held up quite well actually during COVID compared to what we thought would happen in the March-April time frame. So imaging innovation and the products that we have are doing quite well in 2020 relative to what our expectations were.

Next. And then, of course, in the key chemistry business, we have launched rotor chemistry. We think, especially in international markets, those are extremely well-suited for European markets in particular. And we're having good uptake in our Element RC product line.

Next. And our upcoming Element RC3X product, which is just now being introduced in European markets and also was having very good reception early on.

Next. And then Element i+. This is a product that we've been working on now for several years. Again, same thing, product uptake has been quite good. Customers are thrilled with the product performance. It's an immunoassay product that has the ability to build out a substantial menu on a global basis for Heska. It replaces our current Element i. It does multiplexing. It's a superior user interface. It's a superior performing product. It has the ability to grow a much more substantial menu, and it has a wonderful effect of creating better economics for Heska in terms of gross margins and also for our customers. So it's a product release that's going quite well as we conclude 2020, and we see that continuing into 2021.

Next. And then just this month, we will launch the Element COAG+, which replaces a current Element COAG, which is a roughly 15 to 20-year-old design. The new Element COAG+ is a much smaller form factor, it's much more modern. We think it has higher performance. Definitely, in usability studies, customers are thrilled with it. And it also, like Element i+, has the benefit of providing much, much better economics and gross margins for Heska and also for veterinary customers. So we see that product rolling out, both in our domestic markets and our international markets over the coming days.

Next. And then, of course, for those who've been following Heska for some time, the Element AIM, our AI-driven microscopy solution, primarily targeted towards urine and fecal, with the additional upgrade path for cytology. We're very excited about this. We think it's a market that's over $500 million when you combine urine and fecal. And we believe it will be the first truly fit-for-purpose veterinary, I call it a dual threat in terms of the ability to do urine and fecal as opposed to the tens of thousands of analyzers out there that do just urine imaging. So we're very excited about this product.

Next. So some of the design philosophy we've covered in the past, we think we've designed a better mousetrap. It's extremely easy-to-use, and it solves a huge problem for veterinarians, which is looking at fecal. And in fecal, you can think of things like Giardia. My pet has diarrhea, I don't know why. You can think of things like round worm, whipworm, hookworm, tapeworm, those types of things. So in the central reference lab, for instance, you have basically 3 services: you have a blood diagnostics for things like chemistry and hematology; you have then urine and fecal, which would be the other major driver; and then you also have professional services, which would be things like cytology. And bringing urine and fecal in a best-of-breed gold standard way to the point-of-care is something that we think is an enormous problem solver for veterinarians and for pet owners and an enormous opportunity for Heska, both as a standalone product, but also as a product to bundle with our other products to gain market share in other product segments like chemistry and hematology and imaging.

Next. So we're going to go ahead and show you a little bit about that. There'll be an upcoming video here very quickly. But before we jump into that, a couple of just key timelines. These are impending, and we're reaffirming these. We feel like we're on track for limited early adopter installations towards the end of Q2. Teams are working very hard to do that, and we're pleased with how we're progressing.

(presentation video – eAIM product demonstration)

Thank you. I hope that brings it to life for you a little bit. Tying it all together is our HeskaView+ that we've talked about. We've been spending an awful lot of time and effort over the last year or 2 to pull that together. That is our cloud-based solution that takes blood diagnostics data from chemistry, hematology and other analyzers, but it also incorporates it with our digital radiography and ultrasound. We have millions of studies stored in the cloud for that. And we see this as well then incorporating urine, fecal and other types of imaging like cytology and telecytology for telemedicine. So we're excited about that. It ties it all together in a unified portable health record that allows veterinarians to share it with pet owners. But it also allows them to save it for years, decades if they want, and share it and do trending over the long term as well. So this HeskaView+ pieces is at the core of all of these in terms of data management, which we think is going to be even more important in the future.

Next slide.

(presentation video – Lacuna overview)

So This morning, we press released that we're just thrilled to acquire Lacuna Diagnostics. Lacuna Diagnostics is a telecytology business that just integrates just wonderfully with everything that I've talked to you about this morning. The founders will be staying and growing that business with us, and we're just super excited to work with them. Smart, they were founded in 2016, and what they've accomplished from a technology and a team assembly standpoint is just stunning. So Aaron, Garrett and Conor, if you're watching, great job and congratulations, you guys. We're super excited to help you scale this to reach thousands of veterinarians quicker.

Next slide. So in addition to great leadership, great technology, we also inherit a great team. So we have board-certified pathologists on the Lacuna team, and they're really the heart and soul of the business. This is the interaction with the veterinarian. So when you take these point-of-care samples, instead of having a car come and pick up them up and drive miles and pollute and put it on an airplane and fly miles and pollute and drive it to another reference lab and then have it looked at it, there's a better way. And the better way is just digital. And so these fine folks are -- they're young, they're excited, they have a lot of energy. They're veterinarians. They're working with their peers, and they're ridiculously smart. They're board-certified pathologists, and they're the glue that we're just super excited about to bond with customers.

They have turnaround time that is stunning. Normal priority is under 6 hours for turnaround time versus days, in some cases, weeks, for the similar service priority. It can be 2 hours on more normal studies. And then I always love this part, but the RIGHT MEOW, M-E-O-W, 6 minutes. So if you're looking at is a cancer isn't a cancer, things like that, these are really important things to veterinarians and to pet owners, and they just do a wonderful job saving hours, saving money, saving trauma. So we're super excited, and it just fits wonderfully in with our business.

Next. So a little bit on how we see that coming together under HeskaView+ with a telemedicine service. Today, Heska enters the professional services business for the first time. We believe we can grow that business to over $25 million over the next several years relative to our current revenue baseline. We think that's meaningful. But probably, as importantly, it's just a super important service for our clients. And so we intend to take the 65 Lacuna clients that are standalone today, and we think by adding 150 sales team internationally and in North America, Lacuna really does it just through word of mouth, no full-time entirely focused sales effort. We think really adding that capability to it will do the business a wonderful growth turn. In addition to that, we have a very large installed base in North America and also internationally that already do business with Heska, in some cases, on a daily basis and in most cases, for years, in some cases, decades. So we're excited that we think that bonding with those customers will be quite possible.

And then the infrastructure that comes with Lacuna, we're quite confident will be a wonderful ability to add radiology for ultrasound, digital radiography. Interpretations as well, a business that Heska is very strong in, with over 5,000 global installations of digital radiography and ultrasound customers actively working. So we're super excited, that's before we even get to non-Heska customers, competitive customers in greenfield. So it's quite an opportunity. And then, of course, everything funnels into that HeskaView+ which allows us to manage that data and leverage that data in the future back to those bridges that we were talking about in terms of working with pharmaceutical companies, food companies and then, of course, veterinarians. We think those net diagnostic data will be extremely valuable to everybody.

Next. So let's get to what do the multi-financial -- multiyear financial targets. Real quickly, we have a great liquidity position. We have a great balance sheet. We feel like we have good capital to do everything that we're targeting to do. And we continue to invest in new products, and we continue to remain active in the M&A market, like what we announced this morning with Lacuna. And we do expect positive free cash flow, and we continue to expect that.

Next. And so this afternoon, I'm just reaffirming the multiyear outlook that we shared with investors on our Investor Day in November. We think it shows nice top line growth, but also margin expansion. So as we grow top line, we believe very strongly we can grow gross margin and adjusted EBITDA margin as well. We've got a very good solid plan. We're executing to that plan, and we like these numbers. We also think that veterinary health care, in general, will continue to be supported, continue to grow itself, continue to do well. Whether multiple expansion continues at the same rate is a market question always remains to be seen. But we do think that Heska is extremely well positioned for actual underlying profitability growth, revenue growth, and we do think that, that growth will be key to valuation in the next 2 or 3 years.

Next. And we continue to see the market the same way. We think diagnostics is central to treatment, to diet, to veterinary health care services, and Heska sits right in the middle of all of that.

So with that, I will conclude my prepared remarks. Maybe we can get Chris back in the game, and we can take some of your questions with the time that we have.

Question & Answer

Christopher T. Schott – JPMorgan Chase & Co, Research Division – Senior Analyst:

Q. Great. Appreciate the presentation, Kevin.

Maybe just to open up the Q&A, I guess one bigger picture trend I was trying to -- I would love to hear your perspective on is just the overall kind of health of the veterinary market, in particular, diagnostics. I mean, it seems like pet adoptions are up, but as you highlighted earlier in the presentation, that should be a sustainable trend.

I guess the second dynamic, it seems like the spend per visit for pet owners was up quite a bit in 2020. And I just was wondering, is there any onetime elements of that? Or just how are you thinking about that as we look to 2021 and beyond? I'm trying to think, is this a sustained trend? Is this something we should think slows down a little bit next year? Your latest thoughts on that.

Kevin S. Wilson – Heska Corporation – Chief Executive Officer & President:

Yes. So I think it's sustainable. And pattern recognition, I think, is something that I can rely on a little bit. I have been in the space since the early 1990s, so I've seen some of these trends form over time. I think, not to speak for my colleagues in the industry, but most of my peers who I do speak with also think it's sustainable. I suspect there are millions of extra pets in pet homes today. So you take that from 65 million to 70 million U.S. homes and you add 1 million or 2 million there, and you look at what the long-term economic effect of that is, if the average pet is roughly $100 to $110 a month in a spend, that's meaningful, especially because health care for that pet is going to last on the order of 12 to 14 years for dogs, 14 to 16 years for cats. And maybe those pets need friends. So it's a little bit like kids. You think you're going to have 1, you end up having 2, and you might even get 3. So I do think they're sustainable, and pet health care is going to be benefited.

But everybody on that slide that I showed at the end is going to be benefited as well: diet; pharmaceuticals and therapeutics; and then, of course, veterinary health care providers. It is truly a rising tide, I think, that will lift all boats in the space. I do see that continuing.

One other aside, I do think Asia, if you look out over the next 10 to 20 years, similarly with the burgeoning middle class in some of those enormous markets, pet ownership in a lot of those Asian markets is 1/10 of what it is in western markets, and we do think that will change over the long term as well.

Christopher T. Schott:

Q. Okay. Great. Can you talk about your portfolio? I think there's been a view that Heska is maybe a fast follower on the technology front over time. I look at something like Element AIM, it feels like things are trying to change a little bit. So just to talk about the approach you take to innovation and how you are longer term thinking about the evolution of the portfolio.

Kevin Wilson:

Yes. So I would agree with that. I think in Act One back in 2013, we were very much a fast follower. And I don't think that's any different than what you would see with Japanese car companies in the '60s and '70s, Korean car companies in the '80s. There are lots of analogies where I think that's the correct posture and the correct place to start. But we've been very intentional over the last 5 to 10 years to make sure that we move much higher up the innovation chain.

And you're just now starting to see that work that started several years ago. So Element i+ is one of the most exciting things that I've seen because the menu can expand so far. So getting an analyzer platform placed into thousands of clinics is the hardest step. Expanding menu, which is the highest gross margin thing that you can do, it's also less expensive than developing analyzer platforms. It's a much easier step and then increasing utilization, it's similarly much easier from there. And so that's where margins, that's where growth occurs. So we've done a lot of the heavy lifting in the innovation.

And in urine and fecal, in particular, we think we are the innovator. And we're pleased. I think some very big companies will adjust, pivot, whatever the cool business school word is for the year, and may end up following little $200-million-year-revenue Heska. And I think that's great, and I welcome them.

We are quite confident that we will gain a much larger market share of these new innovations than you could gain being a fast follower. We're also quite confident that the innovation builds extremely valuable intrinsic value for the company.

Christopher T. Schott:

Q. Yes. And can you just elaborate a little bit more on how you're kind of accessing that innovation in terms of the -- what's occurring in the market out there and how you're able to bring these products in-house?

Kevin Wilson:

Yes. So some of it is just straight up internal R&D, and a lot of that just term comes from creativity and the whole organization being focused on that creativity. So the closer you are to a veterinarian, the more thoughtful you are about what they're doing in their daily life and how you can fix problems, relieve friction, speed things up by bringing things to the point-of-care. So we're always looking for ways to bring things to the point-of-care.

And once you identify those, then you're set about solving the problem. And sometimes you in-license, so there are technologies out there from the human side or the R&D side or the animal health side that can be in-licensed and then modified and applied to veterinary health. And sometimes, you just do straight innovation on your own, and we've done both. And I think we've been very good, very flexible and creative, especially with our in-licensing deals. So Element i+ would be an example of an in-licensing where it has application in the human side of diagnostics where Heska doesn't play, but we're the best player for that vertical.

And there are very few companies in our space that offer technology creators an avenue to get to the market in countries all over the world at scale. And we're one of a handful, a very small handful that can do that. So we're approached constantly with some very creative things. I think over the years, you'll see things in molecular, those types of things, will continue to migrate from the central reference lab, will continue to migrate to the point-of-care. And so we really are focused on that point-of-care business.

Christopher T. Schott:

Q. Great. And maybe just a last question here. You mentioned the reference lab. The other large point-of-care players, one has a large reference lab. The other one's kind of organically looking to try to build one out. With the lack of a reference lab in your portfolio, how do you feel -- does that hurt you? And how do you overcome that dynamic, I guess?

Kevin Wilson:

Sure. Sure it does. So I would say the 1 player that has a firm handle on both sides of the problem, point-of-care and central reference lab, they have a firm handle on both sides. They've been rewarded with a 55% share in reference lab and a 64% share in point-of-care are the estimates. So they've been rewarded for having a firm handle on both sides of it.

The company that has a firm handle on the North American reference lab without a firm handle in point-of-care has not been rewarded to the same level. And then I think the idea of creating a reference lab and competition with what really is a duopoly in North America is really not something that excites me. What excites me a little bit more is, how do you take the profitable pieces out of the central reference lab and move them to the point-of-care? How do you eliminate millions of miles driven in pollution, millions of miles flown in pollution and millions of hours wasted while you're driving and flying samples around that can be done either through AI, they can be done digitally. If you need a board-certified specialist to actually interact with you, that can be done digitally, just like we're doing today. And you can increase efficiencies, and you can bring those profits to the point-of-care and provide a better result.

So that's kind of where we're focused. I think the historical reward has been there for owning both of those, but I don't think it's mandatory. And just because it's worked in the past, doesn't necessarily mean it's what we want to do in the future.

So railroads are great, but maybe we want to focus on automobiles or airplanes. That's kind of how I look at it.

Christopher T. Schott:

Excellent. We're just about of time. It sounds like a pretty exciting story ahead here, and look forward to seeing the continued progress. But thanks for joining us.

Kevin Wilson:

Chris, thanks, and everybody who tuned in. We appreciate it.