

Q1 2022 Heska Corp Earnings Call

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Final Transcript

Heska Corp - HSKA.OQ - Earning Conference Call/Presentation

Corporate Participants

- Catherine I. Grassman - Heska Corporation – Executive VP & CFO
- Kevin S. Wilson - Heska Corporation – CEO, President & Director
- Jon Aagaard - Heska Corporation – Senior VP, Head of IR

Conference Call Participants

- Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst
- James Philip Sidoti - Sidoti & Company, LLC - Research Analyst
- Benjamin Charles Haynor - Alliance Global Partners, Research Division - Analyst
- Christopher Thomas Schott - JPMorgan Chase & Co, Research Division - Senior Analyst
- David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst

Presentation

- **Operator - -**

Good day, and welcome to the Heska Corporation First Quarter 2022 Earnings Conference Call. Today's conference is being recorded. And now at this time, I would like to turn the conference over to Jon Aagaard, Head of Investor Relations. Please go ahead, sir.

- **Jon Aagaard - Heska Corporation - Director of IR**

Thank you, and good morning, everyone. Welcome to Heska Corporation's earnings call for the first quarter of 2022. I am Jon Aagaard, Head of Investor Relations at Heska. And with us this morning, we have Kevin Wilson, Heska's Chief Executive Officer and President; and Catherine Grassman, Heska's Chief Financial Officer. Mr. Wilson and Ms. Grassman will provide details surrounding the results reported, and then we will open the call to questions.

Prior to discussing Heska's results and before I turn the call over to Kevin, I would like to remind you that during the course of this call, we may make certain forward-looking statements regarding future events or future financial performance of the company. We need to caution you that any such forward-looking statements and opinions are based on our current beliefs and expectations and involve known and unknown risks and uncertainties

which may cause actual results and performance to be materially different from that expressed or implied by those forward-looking statements. Factors that could cause or contribute to such differences are detailed in writing in this morning's earnings release, Heska Corporation's annual and quarterly filings with the SEC and elsewhere. Any forward-looking speak only as of the time they are made, and Heska does not intend and specifically disclaims any obligation or intention to update any forward-looking statements to reflect events that occur after the time such statement was made.

Also during this call, we will be discussing certain financial measures not prepared in accordance with generally accepted accounting principles or GAAP. A reconciliation of these non-GAAP financial measures to the most directly comparable GAAP measures is provided in our earnings release, which may also be found by visiting the Investor Relations section of our website. In reviewing our first quarter 2022 results, please note all references to growth refer to growth compared to the equivalent period in 2021, unless otherwise noted.

And finally, before I turn the call over to Kevin, I want to remind our audience that Heska will host its Investor Day on Tuesday, May 17, 2022. At this event, members of Heska management will discuss the company's growth strategy, recent acquisitions and product launches, new product and solutions pipeline and multiyear outlook, including key drivers and metrics. To register for this event, please visit the events page of the company's Investor Relations website.

With all that being said, it is now my pleasure to turn the call over to Kevin Wilson, Heska's CEO and President. Kevin?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

Thanks, John, and good morning, everyone. Before I begin, I'd like to encourage participants to review this morning's release, I think you'll find it helpful, and I will try to refrain from unnecessarily reading it to you here now. Catherine will cover the specifics of the quarter. So I'll take my time to highlight a few of my own thoughts that may be interesting to you.

To begin, let's run down the list of what's been happening in Q1. First, Heska's market share gains for subscriptions have been faster than they were in the prior year period. So we intend to again finish the year as we have for many, many years with more subscribers than we started the year with. On our last call, for the full year, we shared these good growth goals.

Second, veterinarians continue to rely upon point-of-care diagnostics. Heska's consolidated revenue, point-of-care lab consumables and gross margins are hitting targets nicely higher than last year's very strong baseline in the first half. Third, our new innovation cycle is in high gear now. Primary examples of major new contributors include Element AIM, our highly anticipated Heska Nu.Q Cancer Screening, Heska TruRapids and our timely entry into the practice information management software business. We'll touch more on these initiatives and their associated growth walk at our Investor Day next Tuesday.

Now about supply and demand in pet health care. What we are hearing at the hospital level

is that hospitals have flat to lower by about 100 basis points visit growth. Total hospitals revenue is up mid single-digits, with product sales down slightly, offset by procedures and diagnostics, which are up mid- to high single-digits. And this makes sense.

But let's go a little bit deeper. Demand, we all agree, saw a big step-up in 2021. On the surface, if visits in the first half of 2022 are flat to down, demand must be softening, but that's wrong. There is nothing to indicate that demand for pet health care is weakening. We have said for many quarters now that the pandemic step-up in demand would be largely onetime. And after that, pet health care would hold onto it with go-forward growth reverting to historical growth rates to top the new larger denominator. Historical growth rates for diagnostic-focused companies have been between 10% and 20%. Which is nice, but not always linear period-over-period, especially when matched to comps of 20%, 30% or even 40% in the last year's first half.

But let's get back to actual supply and demand. So if there's nothing to indicate demand for pet health care is weakening, we have a supply issue, which is more correctly a capacity issue. Veterinarians and their staff and their ability to see and treat pets the supply capacity is being outstripped by demand. Veterinary hospitals in the core channel reached maximum capacity in 2021 and without efficiency gains, the constraints on workforce from fatigue, resignation, lower labor participation and rolling COVID days off means that the availability of hospital visit appointments will be capped in the existing channel.

Pet families in 2022 are having a hard time making appointments this week or next week or next month or in some cases, ever. Veterinarians in the core channel are turning away new or less profitable demand, resulting in flat or slightly negative visits growth over last year's peak capacity. It's not that pet families don't want to visit, it's that they aren't allowed to visit. So what we see then is that veterinarians want long-term clients and the best clients to visit, and they want the best procedures to visit, resulting in good growth support for higher-value things like procedures and diagnostic utilization that goes hand-in-hand with them. Both of which we see doing well along with price, which is inflationary.

Now about the unserved. These pet families either make do without, they wait or they find alternative channels like mobile, pop-up, big-box clinics and the like, and those alternative channels don't show up in most industry measurements of visits, and that's important to remember. So going forward, supply will adjust to meet demand via efficiency and new supply. I believe that markets work. And for example, I'm seeing for the first time in many years, the first meaningful wave of new stand-alone traditional clinic formation alongside less traditional rollouts. These new capacity initiatives and efficiency gains will fix supply and visits constraints.

Some supply constraints will be relieved with efficiency through things like practice and customer software and automation, a business that Heska has now entered in time to capture the upcoming upgrade cycle to cloud and mobile-centric solutions that incorporate much more automation and predictive medicine from big data learning. As a provider of efficiency solutions, Heska loves high demand that cannot be served by current supply and efficiency. We will help solve these problems for new capacity providers, and we will help better

efficiencies occur for current capacity providers, and we will be rewarded for doing so.

We will make hospitals, staff, pet owners and interactions between them more efficient. We will remove frictions and speed up time to actionable results by bringing them to the point of care, and we will automate the communication of those results. Heska will make each interaction more profitable while realizing better pet health and better business outcomes. In short, we will empower veterinarians who will service growing pet health care demand rather than turn it away. This is the opportunity and Heska is wonderfully positioned to grab it.

I hope you will attend our upcoming Investor Day next week, where we will begin to share and overview as much as is competitively prudent, how Heska is delivering on this opportunity. And now a little bit about the macro backdrop. Pet health care is in good shape. We're in the middle of a decade's long super cycle, and we see that demand for pet health care is not slowing in 2022. For a couple of years now, we have communicated that pet health care was great before, will be great during and will be great following the pandemic.

Today, I'll expand that list. The same is true for macroeconomic periods of quantitative tightening, inflation, higher interest rates and lower money supply. And the same is true for periods of geopolitical decoupling and tension between democratic society and authoritarianism. We are not a state at home play. We're not a return to work play. We're not an inflation, reflation or deflation play. We are not a geopolitical Game of Thrones play. But what we are is a really well-positioned investment in North America, core Europe and Australia, New Zealand, pet health care in what we think is the best part of pet health care.

Diagnostics and informatics under Heska's bundled subscription model is really well positioned. Heska has secured the capital, people, portfolio, supply chain, end markets access and contract terms in and out to grow in both Sunday and unsettled times. We're a good, solid investment with really strong and clear growth prospects in our 5-year plan and beyond. And while the entire pet space has seen valuations come down due to factors not necessarily correlated with business and prospects, taking most of us back to the fall of 2020 in terms of share price, I think the market and the systems are working, if not perfectly, directionally. And I think that gap between perfectly and directionally is an investment opportunity, especially as investors sort between the discrete and not necessarily correlated prospects of the companies directly or indirectly serving the pet market.

Investors have correctly formed capital around Heska, and Heska is investing this growth capital in support of our human capital, strong capability, hard work, good market and great prospects to solve problems for veterinarians and pet families and we will be rewarded for doing so. I'll leave it to much smarter people to figure out if and when we are a good trade, but I'm very, very confident we are a great investment.

Today's Heska has created one of only 2 unified offerings to serve all of the veterinarian diagnostic and informatics bundled subscription needs. We expect to achieve our full year outlook, including reported sales growth of 13% or more and North America POC lab consumables growth of 15% or more. Despite being nudged to the low-end of our range by prudent acknowledgment of a more unsettled macro backdrop and by a more variable

quarterly peer set sentiment than normal, net-net, we see strong fundamentals for pet health, point-of-care diagnostics, informatics, our new product cycle, pricing and Heska's positioning, especially as we indicated on our last call in the back half of the year when our newly releasing products recurring utilization begins to show more fully in our results.

Now I'll turn the call over to Catherine to detail the quarter before we move into our Q&A time. Catherine?

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

Thanks, Kevin, and good morning, everyone. Coming off a strong finish to 2021, Heska delivered a solid start to 2022, performing in line with our expectations. We reported total revenue of \$64.8 million, an increase of approximately 7% and approximately 10% on a constant currency basis. Our North America segment revenue was \$37.4 million for the first quarter. Our point-of-care diagnostic laboratory products grew 16.8%, which was driven by approximately 10% consumable growth and increased capital placements, including Element AIM, offsetting the quarter performance for this segment was the timing of our contract manufacturing sales.

Our International segment reported quarterly revenue of \$27.4 million, growth of approximately 18% and 25.5% on a constant currency basis. Driving our growth is the transition of our customers to the reset subscription program within POC Lab, solid capital placements of POC imaging products and the acquisition of VetZ, which established our presence in the practice management information software market. Consistent with our stated strategy, we continue to pursue acquisitions and partnerships, which serve to enhance our product portfolio and geographic reach.

Our international POC consumable sales on a reported basis is down to prior year as a result of FX. Excluding this impact, our consumable sales grew around 3% from the prior year. Consolidated gross margin increased approximately 290 basis points to 45%. The North America segment delivered gross margin of 47.9%, a 90 basis point improvement. The expansion was driven by favorable mix as we continue to drive growth in our key recurring consumable revenue. International segment gross margin for the first quarter was 41%, an improvement of 670 basis points. Heska's international products rationalization and conversions to subscriptions are progressing well. This improvement is indicative of that success.

To remind you, the accounting for conversion to subscriptions will at times dampen reported sales dollars from consumables as discounts are shared with new subscriber activations. Because of this and other mix impacts, this improvement will not be linear, also favorably impacting the international gross margin as our acquisition of VetZ.

Total operating expenses were \$40.6 million. The increase of approximately \$16 million was driven primarily by onetime charges of \$11 million, \$10 million of which is related to the contractual license payment due upon the execution of the exclusive agreement to develop the Heska new Nu.Q Vet Cancer Screening Test. Acquisitions added operating expenses of

\$2.6 million, a portion of which increased R&D as we continue to develop products and services for future growth, and the remaining increase is mainly in compensation in both short and long-term incentives.

Adjusted EBITDA was \$7.7 million or an adjusted EBITDA margin of 11.9%, a 200 basis point decrease. This was driven by increased investment in recent acquisitions, mainly in R&D, as noted, as well as previously mentioned cash compensation as we continue to invest in talent and processes in addition to new products and technologies. We had a loss of \$0.97 per share in the first quarter. Adjusted earnings per share was \$0.27, a decrease of \$0.32. During the quarter, we put approximately \$40 million to work on investments and acquisitions of businesses and partnerships, both establishing and even creating market opportunities. Our balance sheet is secure with cash of over \$172 million.

Turning now to the financial outlook for 2022 previously provided on February 28. It is not our intention to update guidance quarterly. However, in light of macro environmental and geopolitical concerns as well as industry-specific trends, we believe it is important to communicate with our investors and analysts on the health of our business, which remains strong. We communicated a guide of \$287 million to \$297 million for consolidated revenue, POC Lab range of \$170 million to \$180 million, including growth rates of consumables in North America of 15% to 20% and approximately 5% for international. We are reaffirming our guidance, and we believe we will achieve the lower end of the consolidated revenue range at or around \$287 million, which includes achievement at the low-end of the North American consumable growth rate previously provided at or around 15%.

Our revenue estimate and growth rates include consideration of the lapping of a strong first half of 2021 with an assumption of that clinic capacity adaptability in the second half, coupled with net price gains. Additionally, our second half of 2022 includes commercial initiatives such as our planned launch of Rapid Test and a heavier Element AIM placement plan, as we've previously discussed. Our profit-related expectations remain unchanged. Based on our recent use of cash for the cancer and screen and monitoring test development, in addition to stocking initiatives to secure supply, we will not generate free cash flow in 2022.

With that, we would like to open the call for your questions. Operator?

Question And Answers

- **Operator - -**

A. (Operator Instructions) We will hear first from David Westenberg with Piper Sandler.

- **David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst**

Q. So let's start off with the guidance or the reiteration of guidance. I mean you -- the quarter was -- I mean it wasn't bad. I mean, it was down -- it was just a couple of million dollars below, I guess, consensus, not necessarily your perfect guidance here. But the investors that

might think that maybe you're a little bit overconfident with the reacceleration growth in the back half of the year implied by keeping the guidance. Can you talk a little bit further at length and kind of what gives you that confidence that there would be kind of that reacceleration of growth? I mean you did touch on some net price gains and need to touch on some comps. Can you give maybe a little bit more details there and if there are any other factors of consideration there?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes, David, I think the biggest one would be comps. We like the first quarter revenue performance. So I think the biggest one will be comps. And I think you and the analysts that follow the company understand how our price drips in, we take price on a monthly basis. So basically, customers annualize. And so as that price drips in for existing customers, I think that accelerates in the back half. And then I think the third thing would just be when you're placing analyzers like Element AIM, the consumables pull-through on that accelerates when you have more Element AIM placed. And so every month, we continue to place more and more brand new analyzers. And as that snowball gets bigger, you get more consumables growth in the back half. So I think it's consistent with our plan. We're just acknowledging that it's a little bit rougher out there. So we're down towards the lower end of our guide, but we're not changing our guide, and we weren't disappointed with the first quarter. Catherine, do you have anything to add on that? I think those are the big 3.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. That's great.

- **David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst**

Q. Yes. I appreciate that. That's a great answer. Okay. And then secondly, we're getting a lot of questions here on -- if you're able to quantitate kind of the subscription conversion in the EU? Is it the speed according to plan? Is it above plan, below plan? Any kind of quantification because I think people are really interested in knowing when that becomes kind of that tailwind in that business?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. I mean I think what I've said in the past is it's an ongoing thing. So we're -- if you look at the top 30% of customers who generate 70% of the sales, we're over halfway through those. So those are a lot of percentages. But that still leaves 70% of the customers who generate 30% of the sales, and we're less than halfway through those. So I would expect that to continue really for the balance of this year. But I don't really see it hurting us. I mean I think the performance has just been wonderful. I think their consumables growth is good despite the dampening effects of the price, moving people to subscription, I think their gross margin performance is fabulous. I mean when we bought that business, it was maybe 31%, 32% gross margin and I think they've done just an amazing job over the last 2 years. So I

would expect it through the balance of this year for sure. And then I would expect us to update next year. I don't think it will take all the way through next year. If that's the question, it's not for everything, but it will be present for the full year this year.

- **David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst**

Q. I'll hop back in queue. I got a couple more.

- **Operator - -**

A. We'll now move to a question from Chris Schott with JPMorgan.

- **Christopher Thomas Schott - JPMorgan Chase & Co, Research Division - Senior Analyst**

Q. I just had a maybe a 2-part question around this vet capacity constraints. I guess the first in, it seems like we've been hearing about this issue for a while. I think you've talked about this in prior calls. So I'm just trying to help us understand a bit what I guess, changed between when you issued guidance, I guess, back in February versus where we are now? I know you're not formally changing guidance, you're just at the lower end of the range, but it does seem like from what you're seeing and what your competitors are seeing that it does feel like the environment did kind of pivot a bit in the last few months. So maybe starting with that one. Just help us a bit as the year has progressed, is this just kind of come to a head at this point? Or is this something that's not all that surprising to you based on, I guess, what you were seeing as you went through 2021?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. I don't think it's terribly surprising. If I go back to 2020 and 2021, it was in my prepared comments a little bit that we think things would normalize back to the 10% to 20% range. And I think when you strip out constant currency and things like that, you're finding that our peer sets kind of in the lower end of that range but within that range. And I think you're off of very difficult comps, especially in the first half. So percentages are funny things. So I don't think any of this is really surprising. I mean, look, Chris, it takes 8 to 10 years to make a veterinarian. We can't just spin up the veterinary factory and fix constraint, which is a good fact for companies like Heska, especially if you're in the efficiency business where the practice information management and communications to pet owners and some automation in that efficiency is what fixes supply constraints often. And it's not just the blunt instrument of more veterinarians. So I don't know that it's really a surprise, and I don't really feel like anybody in the industry has fundamentally changed, and I'll say, directionally. But if you trim a point or 2, I think I've heard that across the industry a little bit, but I don't think anybody is really surprised by this.

- **Christopher Thomas Schott - JPMorgan Chase & Co, Research Division - Senior Analyst**

Q. And then just a quick update on the Element AIM rollout and feedback you've got from customers make us an update of how many devices do you placed at this point? Any changes in the goals for the year or just general acceptance of the product so far with any additional color would be appreciated?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. I mean I'm the CEO of the company, who just gave birth to a beautiful baby boy or girl, so I think it's great. But feedback from customers has been wonderful feedback from our team. We have people on our own veterinary diagnostic lab, our own internal lab and have 20, 25 years of experience of making slides and looking at urine and fecal for research purposes and Element AIM actually outperforms people with 20, 25 years' worth of experience in that with top-quality microscope. So the performance, I think, has been fantastic.

Our supply chain remains intact, and we remain on track for where we said we'd be for the full year. We're not going to call out quarterly placements, but we're on track for our full year and that's all part of our sticking with our guide. So we like it. We'll update a little bit more on Investor Day next week, but it's going well.

- **Christopher Thomas Schott - JPMorgan Chase & Co, Research Division - Senior Analyst**

Q. Good to hear. And one last really quick one. Really strong gross margins internationally this quarter. That 41% gross margin, is that kind of -- I know it might be a little choppy, but is that kind of a sustainable number? Or just how should we think about the international gross margins as you've got through more of the conversion cycle at this point?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. Catherine, do you want to speak to that first?

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes. So I would say that not only will the conversion cycle impact that margin going forward, right, the number by quarter. We're also going to roll out Element AIM as well there, and I think we described on the last call, the compressing impact of that instrument. So we still maintain our full year guide on the consolidated range of an improvement of 100 to 200 basis points off of last year. So not linear, but certainly something that we're looking forward to once we've lapped some of these placements that tend to compress the margin.

- **Operator - -**

A. We'll now move to a question from Elliot Wilbur with Raymond James.

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. Just 2 quick ones for Catherine upfront. Back on the topic of international gross margin trends. Is there an FX impact on that number? And if so, how significant is relative to the revenue impact. And you also called out various stocking initiatives in the quarter. Wondering what the impact was on cash utilization in the period. And I have a couple for Kevin as well.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes. Yes, so we did order ahead, especially in our international segment. So definitely taking the projected use of cash to a more neutral position if we exclude the impact of the \$10 million we paid for the exclusive rate to develop the cancer screen test. So certainly having a pretty significant impact, not a long-term one, obviously, just more of a stocking. And then -- sorry, can you repeat your -- the first question?

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. Sure. On international gross margin performance, just trying to understand how FX may impact margin levels.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. It wasn't an overly significant impact to the margin level to the -- yes, it just wasn't overly meaningful to the margin on the quarter.

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. Okay. And then just 2 quick ones for Kevin. Just going -- following up on some of the earlier questions around Element AIM and the placements there. My assumption would be that once it's placed in a practice that conversion is very rapid, almost 100%, but maybe that's not correct. Just wanted to get a sense of sort of what the conversion is in terms of utilizing AIM for all the daily fecal test, whether or not there's an adoption curve there. And then...

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. That's a great question. Go ahead

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. I've got one more for you. Now just a big picture question on business development and the strategic front. You guys have been incredibly busy in the last 12 months. You're still relatively well armed. How do we think about capital deployment initiatives over the next 12 to 18 months in terms of pace and some of the additional areas you may invest in? Do you have all the key pieces in place that you want to have in place, and now it's now. It's just a matter of investing more heavily in those businesses? Or do you think there's still additional adjacencies that you'd like to potentially explore?

And then I'm curious if the contraction in public market valuations in the animal health sector, in general, has begun to work its way into private markets and whether that may open up even additional opportunities for you?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Those are all great questions. So I'll just take them in order. Element AIM conversion is very quick, but it's not instantaneous. So you install -- obviously, you install with a starter kit of consumables, and then they work through that first month's utilization. But you're still changing behavior. Every technician, every doctor has to get used to doing it in a certain way. But the conversion on it is fairly quickly. So I would say it's within the first quarter, you kind of get to normal run rates.

And remember, most of those customers do other things with us. So they do chemistry, hematology, blood gas, immunoassay, they have a whole portfolio of products with which to hit generally their increased minimum. So their minimum goes up 1,000 per month because there's an Element AIM just to keep the numbers around. They might not do all 1,000 of that in just Element AIM. They might do some of that in increased chemistry and hematology and associated tests. But for the most part, the pull-through on it is fairly quick.

With regard to capital deployment, we're largely in the portfolio that we like. We've assembled the asset that we like, but not in every geography. So you could look at it and say, from a consolidated level, I look and I say, we have all of the pieces of the portfolio. So we have point of care. We now have rapids. We have practice information management software. When you just go through the portfolio, we have the things that we want. We have imaging. Now what we have to do is we have to take where we're strong and we have to export that to other markets.

So meaning we might have a wonderful 30% market share in Practice Management Software in Germany and 70% in the biggest hospitals in Germany. We say, "Wow, that's great. We need to export that excellence in that capability to the North America market to France, to Italy, to Spain, to Australia to the other markets. And then we might have a nice little reference lab business in Italy, and we've worked out the business model, and now we need to export that to Spain and France and Germany and other markets as well.

So that's how I look at it as we've confirmed the ability to bundle. We've confirmed that we have the right portfolio. And you've heard me say for years, I try not to scale things that don't work. So we run little sandboxes before we try and make new sandboxes or bigger

sandboxes. And that's what I mean when I say we're going to win at scale. That's what I mean by that. Did you answer the question?

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. No, that's great. And then just as a corollary to that, just sort of curious in terms of some of the trends you may be seeing with respect to the private market valuations, whether or not they may have begun to reflect the valuation traction in the publicly traded names within the space?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. So private markets tend to lag public markets a little bit because they don't mark-to-market by the minute and by the day, so they can pretend a little bit longer. But I think we've been in a down and compressing market now long enough that I am starting to see expectations fall. So it's not really just, hey, what was my last round at. That's not necessarily an anchor anymore. I don't know that it has a huge impact for us. We're doing business development like our Heska Nu.Q investment in cancer, I think, is a monumental wonderful business that we can lead in that is a huge total addressable market. And that's a licensing technology.

I look at it as off-balance sheet development that these people have worked very hard to create an amazing thing that can work well on our portfolio that's already installed and installing in hundreds, if not thousands of locations. So the uptake and the growth curve could be good as we finish this final development phase. So doing deals like that, I don't know that are really -- they're not really equity deals. They're more commercial. I do think everybody's valuation expectations are dropping. I mean, I'm looking at acquiring Zoetis. I can't figure out where to get all the money for it, but I'll let you know if I figure it out. I'm kidding about that, by the way.

- **Elliot Henry Wilbur - Raymond James & Associates, Inc., Research Division - Senior Research Analyst**

Q. I'd say the debt markets are still cheap, but that probably would get some per.

- **Operator - -**

A. And now we will move to Ben Haynor with Alliance Global Partners.

- **Benjamin Charles Haynor - Alliance Global Partners, Research Division - Analyst**

Q. First off for me, the obligatory international gross margin question. Just was curious on how much of a contribution Fed was to the expansion there?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. So I think, Catherine, you probably have a directional number. I don't know if we're breaking it out, but you may be directional.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes. Yes, it's certainly software like gross margin for that business. So it's a couple of hundred basis points, predominantly still driven mostly by point-of-care lab in the consumable improvement, but certainly a key contributor to the \$670 million in total.

- **Benjamin Charles Haynor - Alliance Global Partners, Research Division - Analyst**

Q. Okay. And then maybe following up on an earlier question on the exchange rates and the recent dollar strength. Does that impact your guidance at all? I know you mentioned that didn't really do much of the gross margin. But I think one of your competitors called that out as reducing their forward guidance?

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes. It's certainly part of taking the total guide to the lower end of the range.

- **Benjamin Charles Haynor - Alliance Global Partners, Research Division - Analyst**

Q. And then Kevin, in the prepared remarks, you highlighted the kind of the share price returning to 2020 levels, given that you've got a pretty healthy cash position, would you or you guys or the Board potentially consider share repurchases?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. I've thought about that deeply, by the way, I personally hold a handful of shares as well. So I pay attention to the share price, and I'm very sensitive to everybody on a call like this makes a living. But having said that, at the end of the day, we have growth capital to grow, and we have really great ideas to use that capital to grow. And I think we get paid to deploy capital to solve the efficiency and capacity problems of our customers in ways that pay us over a long period of time. So that's a long answer to say I think we have better ways to deploy that capital than returning it to shareholders via either stock purchases or things like that.

So we're a growth company, and we're growing and our market is growing, and our product development is growing and grow, grow, grow. And the macro environment around that, if the painting behind us changes, I will feel badly that it's changed, but it will change again. And our growth and nothing solves valuation issues like growth and positive free cash flow. So this is what we're paid to do, and we've got a 5-year plan where we're going to grow at scale. And we mean it, and we're going to use innovation. We're going to win it innovation, and we mean it. And I think that's why people have given us a couple of hundred million

dollars of their investment money so that we can build products and invest it on their behalf, not play the stock market.

- **Benjamin Charles Haynor - Alliance Global Partners, Research Division - Analyst**

Q. Yes. Well, I appreciate the thoughts. That does make sense. And I guess I'll leave the rest of my questions for next week.

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. We appreciate it, Ben.

- **Operator - -**

A. We'll now hear from Jim Sidoti with Sidoti & Company.

- **James Philip Sidoti - Sidoti & Company, LLC - Research Analyst**

Q. Can you talk a little bit more about Nu.Q. What you need to do to launch that? When do you think that will be? And how do you think you'll price that?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. So we'll talk a little bit more at Investor Day, but I can field most of those questions. It will be priced most likely in the mid-20s, low-30s. And so we think that's just super accessible, especially for annual use for cancer screens and things like that. And so one of the biggest things in our business is certainly annual screens for things like heartworm and thyroid and age-related things and cancer certainly falls into that, especially breed specific. So we think pricing it at that level opens up just a huge market.

In terms of when we think it will come to market, we're pushing hard for this year towards the end of this year. But if not, we think it's in the first half of next year. But it is product development. But we think that's possible. We think that's doable. So that's what the team is pushing for.

- **James Philip Sidoti - Sidoti & Company, LLC - Research Analyst**

Q. All right. And you and everybody else on the planet is talking about the currency headwind. But you have a considerable operation overseas. So will that be offset by some natural hedges?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Catherine, I know you've looked into that. I don't know that we put currency hedges on.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. No. We have not... We've been evaluating.

- **James Philip Sidoti - Sidoti & Company, LLC - Research Analyst**

Q. I meant hedges to the -- well, the fact that you have so many people working overseas that you're paying in those currencies will that offset the impact to the bottom line?

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. You said natural hedge. Is that what you said?

- **James Philip Sidoti - Sidoti & Company, LLC - Research Analyst**

Q. Natural.

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes, we -- I mean -- and so the FX on the bottom line, so when we talked about margin, we're not seeing -- it's obviously part of the reason we can keep the profit-related targets the same, certainly more on the top line. We do have some exposure. We buy in USD for our European -- part of our European supply. So we are actually looking at hedging arrangements on those.

- **James Philip Sidoti - Sidoti & Company, LLC - Research Analyst**

Q. And then I'm not sure if you said it at the end or not, Catherine, but did you talk about free cash flow for 2022?

- **Catherine I. Grassman - Heska Corporation - Executive VP & CFO**

A. Yes. I just indicated that it would be -- we would not be generating free cash flow given the investments we made this quarter -- or this first quarter for the cancer screen. Additionally, we did procure supply ahead. So we've used cash ahead. And therefore, we'll probably be closer to neutral on a cash flow generation for the year, excluding the impact of the \$10 million.

- **Operator - -**

A. (Operator Instructions) We have a follow-up question from David Westenberg with Piper Sandler.

- **David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst**

Q. Just with the topic does your labor supply here. Can you give us a thought on how a veterinarian practice might think about adopting the Element AIM and face of supply constraints. I mean I think there is a send-out model that some of your competitors deploy sort of obvious that you would take a container, send it out the veterinarian doesn't see it. But is there some ability in the in-house model to actually also kind of fix the workload and help supply for the veterinary care to the Element AIM?

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Yes. super interesting in the last quarter that I think point-of-care for the one competitor that has meaningful point-of-care and send out reference lab, I think point-of-care outgrew send out reference labs. So I think it's an interesting data point, but it's only 1 quarter and it's only one data point. Look, I think there's more to efficiency than just technician time. Callbacks take a lot of time, and they're far less gratifying for pet owners. So if you can get everything done in an exam time window and you can release the pet and the pet owner with all of the information without having to do follow-up calls at the end of the day, that's a huge time saver.

So I think we're still going to see forever the same tension between whether it's better to send something out because I can just drop in a box, whether it's better to do something closer to the point-of-care and closer to the communication event with the pet family. Generally, if you have a really quality solution, generally, I think veterinarians will prefer the point-of-care because it improves the service and it improves the satisfaction. And I think ultimately is more efficient because they're not chasing things after the fact and they're not having to reduce things after the fact and say, what was that case again? What was the background? What was the clinical, -- what were the associated diagnostics related to that number going back and rechecking those types of things and then communicating them after the fact is not very efficient. So we still like point-of-care, and we still like reference lab. I don't think it's necessarily a zero-sum game.

Element AIM in that regard, I think, is doing great. By the way, people love to get rewarded with great interesting results. When you run a fecal and you accidentally discovered Giardia, that's pretty interesting, especially given the fact that you might not be sending fecal out to be tested for Giardia. So the incidental findings that happened at point-of-care are quite rewarding as well.

- **David Michael Westenberg - Piper Sandler & Co., Research Division - MD & Senior Research Analyst**

Q. Appreciate it. Look forward to seeing you next week or talking to you next.

- **Operator - -**

A. And it appears we do not have any further questions in our queue. I'll turn the call back over to Kevin for any additional or closing remarks.

- **Kevin S. Wilson - Heska Corporation - CEO, President & Director**

A. Thank you, operator. Thank you to everybody who joined the call. Before hanging up, I want to quickly remind everyone to join us next Tuesday at our Virtual Investor Day where we will have a number of people from our leadership team available and presenting and available to you. Thanks, and have a great day, and we'll talk to you soon.

- **Operator - -**

A. With that, ladies and gentlemen, this does conclude today's conference. We thank you for your participation, and you may now disconnect.