Q3 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
- Erin Elizabeth Wilson Wright - Morgan Stanley, Research Division - Equity Analyst

Presentation

- **Operator - -**

  Good day, and welcome to the Heska Corporation Third Quarter 2022 Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. John Aagaard, Director, Investor Relations. Please go ahead, sir.

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

  Thank you, and good morning, everyone. Welcome to Heska Corporation's earnings call for the third quarter of 2022. As a reminder, today's conference is being recorded. I am John 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 the 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 statements speak only at 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 third quarter 2022 results, please note all references to growth refer to growth compared to the equivalent period in 2021, unless otherwise noted. With 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 a detailed and helpful and I'll try to refrain from unnecessarily reading it to you now. As usual, Catherine will cover the financial results from the quarter, and I'll take some time now to share a few of my own thoughts. To begin, there's a lot of great performance in last quarter's results, especially in profitability year-over-year. North America POC lab consumables were up 11.4%. Gross margins on a consolidated basis, up 180 basis points. GAAP EPS up 78.9% and adjusted EBITDA up 12.3% are all fantastic results, especially in light of some softness in reported revenue. While it's always great to beat and be in today's macro environment and in Heska's specific progress. Overall, I'm pleased and I congratulate our team on controlling so strongly the things within their control and mitigating those things that are less controllable. We are a much, much stronger and better positioned company today than we were in January. As we dive in further, I think it's helpful to frame the period's impacts into 2 categories, the first being the macro drivers or what we have less control over, and the second being Heska specific or what we have more control over. The macro drivers are widely known. Foreign exchange is a big one, inflation, interest rates, pandemic revenge travel, labor constraints, supply chain, energy inflation and vet visit trends round out the list. Heska is impacted by each and in my opinion, done an admiral job mitigating each. The third quarter for Heska fits squarely into what we are seeing and hearing within the industry, and this is reflected in our guide for the whole year result. I won't drone on about any of these broadly felt trends here, but we'll be happy to answer questions or provide more commentary around those of interest to participants in the Q&A. Specific to Heska and the things we can and should control, we have done well in many but can do better. So far in 2022, we were slower than intended in launching and accelerating traction for things like Rapids internationally, heartworm domestically and Element aim into Europe and into North America corporate contracts as quickly as intended and in time to make a financial impact on 2022 that could overcome the accumulated macro headwinds. That's the demerit for today, and it's reflected in our guide for the whole year result. The good news is that the calendar is now our friend entering 2023 as we lap these demerits and they turn into positive contributors. Rapids are in our warehouse and ready to go with a full menu internationally and heartworm approved by regulators for sale domestically. Element AIM is in our international warehouses. Sales and marketing materials and teams in each core country are ready and orders are being placed and filled. In North America, as of November, after a longer process than anticipated, Element AIM is now authorized for hospital selection and installation in nearly all of our corporate contracts to serve good demand rising up from the hospital level from some of our largest customers. Chief Medical Officers are convinced, performance has been very well received. Our CE seminars are extraordinarily well attended. Our pipeline is great, and placements and utilization are growing regularly and consistently, pointing to Element AIM being a solid, differentiating and growing success that we see strongly contributing to our financial and portfolio performance for many, many years. To the extent we are doing a forward-looking probability exercise, these 2022 delays are now all set to reliably flip into strong reported and comparable contributors in 2023. Add to these, the growth that we expect from 2023 launches of our new cloud-based PIMS and our exclusive new cube vet cancer screening, all supported by what we anticipate to be more favorable trends in prior year comparables. And our line of sight for 2023 growth becomes clearer and confident. The timing is good. For nearly 5 years, we have planned and publicly communicated that Heska was targeting 2023 to transition from our 5-year build phase to our 5-year win at scale and win an innovation phase. We have assembled an amazing and very unique asset. The time is ripe and we are ready to go. With that, 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. I will take you through the quarter performance as well as how we see 2022 wrapping up with 7 weeks to ago. We reported total revenue of 61.5 million, growth of 2.1% and 7.1% in constant currency. Our North America segment revenue was 40.3 million for the third quarter, which reflects growth of 6.7%, primarily driven by POC lab consumables growth of 11.4%. Our consumable growth included increased utilization of newer product launches from investments in innovation such as Element AIM and telecytology as well as pricing gains from our annual subscription price adjustments for the greater of 4% for CPI, which occurs throughout the year based on contractual agreement dates. POC imaging drove about 3.4% growth on a very high comparable period. We also saw growth of 24.3% within our PVD business, which reflects timing of Tri-Heart shipments as compared to the prior year period. Our International segment reported quarterly revenue of 21.2 million, a decline of 5.7%. This represented growth of 7.3% on a constant currency basis as foreign exchange was a significant headwind in the quarter. Contributing to the growth is our new vet presence in the practice information management factor Mike, in addition to continued transition of our customers to the reset subscription program within PSD lab. The macro environment in the European region impacted vet visits and consumer spending, coupled with our purposeful transitioning of existing customers to subscription program in which we share price discounts in exchange for longer-term contracts and other benefits resulted in a decline in sales of consumables of approximately 2.7% on a constant currency basis. Consolidated gross margin expanded 180 basis points to 43.7%. The North America segment delivered gross margin of 46.5%, an approximate 50 basis point decline due to product mix. International segment gross margin was 38.4%, an improvement of 512 basis points. Product rationalization from the aforementioned strategy of transitioning existing customers to long-term POC lab subscriptions drove margin expansion on consumables. VetZ software sales and services also favorably impacted gross margin. Total operating expenses were 27.5 million, roughly in line with the prior year. Adjusted EBITDA was 6.3 million or an adjusted EBITDA margin of 10.3%, a 90 basis point reported improvement or 50 basis points in constant currency. This was driven by improved gross margin gains, partially offset by increased investment in recent acquisitions for the development of new technologies and products. We had a loss of $0.04 per share in the third quarter. Adjusted earnings per share was $0.41, an increase of $0.21 over the prior year period. Our balance sheet is secure with cash of 161.1 million. Consistent with our stated strategy, we continue to actively evaluate capital deployment opportunities and have committed 25 million in cash as part of the acquisition consideration of MBio which we announced in September. As we wrap up 2022, we expect continued headwinds from foreign exchange, international economic uncertainties impacting short- and long-term capital decisions as well as price sensitivity and consumer spend. Delayed commercial success from our True Rapids launch, which missed the 2022 selling window and will not be recaptured this year will contribute in 2023. Pressure on labor inflation and financing for new capital equipment placements and training is expected to affect growth in imaging devices, including digital radiography, ultrasound, Element AIM and HeskaView telecytology in the final quarter of this year. We have also experienced supply chain and forecast changes within our contract manufactured products impacting 2022. With these factors in mind, we believe it is prudent to expect consolidated revenue to be roughly in line with the prior year reported revenue, which as we've noted, reflected historic pandemic-related growth for the company. This revenue outlook represents around 5% constant currency growth. North America consumable growth of 8% to 10% is expected, which includes net subscriber gains in 2022. International consumable sales, as reported, will decline approximately 12% due to foreign exchange, but remained in line with prior year, excluding currency impact. Profitability expectations remain largely unchanged and that we expect to gain 100 to 200 basis points on gross margin and an adjusted EBITDA margin of approximately 11% as we continue investment in planned product launches to drive 2023 and beyond when we have been targeting for some time to transition from a 5-year build plan to our 5-year went scale and win innovation plan. With that, we would like to open the call for your questions. Operator?

Question & Answers

- **Operator - -**

  A. Thank you. (Operator Instructions) if you would like to ask a question, please restore. And we'll take our first question from Chris Schott with JPMorgan.

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

  Q. Great, thanks so much for the questions. I guess the first one is just I was looking for a little bit more color in terms of what changed from the 2Q call until today? Because it seems like some of the challenges you've been facing in the business, I think you've articulated throughout the year, but they did seem like they get more acute, I guess, over the last few months. So maybe specifically, U.S., I think you're talking about VetZ is starting to recover, but the guidance is coming down a bit. Help me there a bit. And then Europe, it seems like a little bit more dramatic pivot in growth rates. So also maybe just elaborate on the trends you're seeing there. And then I just have one follow-up after that.

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

  A. Yes, Chris, I'll start it's Kevin. On the Q2 call, we weren't seeing the things in our numbers quite as much. And I think Europe has come in a little bit worse. I think if you look back at the news cycle over the last 3 months, certainly with Ukraine, we hear energy inflation. So we have examples where winter heating costs double, triple. And I think if you pull EUR 1,000 or more out of a monthly budget for a German family, I think that causes some potential caution, certainly causes caution also in the veterinarians. So I don't think it's a new trend, it's just that it showed up in our numbers more and we think it would be prudent to just kind of extrapolate that going through the fourth quarter as well. I think I answered the question in terms of U.S. veterinary visits, I think we're seeing the same thing that everybody else is seeing. It's kind of gone from down 4% visits year-over-year to 3 to 2, 2.5. And I'm just using broad numbers, everybody is within 10 basis points, 20 basis points of each other from what we're hearing. And it's a trend, but it doesn't show up in your numbers instantly. And so we could be positively surprised that maybe that trend continues and you get closer to a year-over-year, maybe you get down into the 1s if that trend continues but maybe you don't. And with 6, 7 weeks left in the quarter, we just think it's prudent to just say the environment is what it is. We're seeing it in our numbers so let's go and extrapolate that through the end of the year and make sure that we're ready for year-over-year '23 to get back to growth.

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

  Q. Okay. And then just one follow-up and then one additional. I guess the follow-up was just given the macro environment in Europe, does it make sense at any point to either pull back or slow a bit the things like Element AIM, is it just the right environment, I guess, to be launching a new product, and we just love your thoughts there. And the second one is, I know you're not updating 2023 guidance right now, but just maybe qualitatively, can you talk about how you're thinking about those targets in light of the environment we're seeing? I guess do you expect enough of this to rebound next year, those targets still make sense or do we need to maybe rethink those a bit just given what's happening particularly in Europe.

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

  A. Yes. I think it's prudent to rethink 23 numbers as well. But we do think that most of these trends moderate. But again, I'm not a currency speculator, so 4X obviously is a huge one. But I don't see the currency moving another 15%, 20% of where we are today. I don't see interest rates having the same velocity and amplitude of moves and all those kinds of things. So I think it's prudent to look at it. Offsetting that are some new products that we think will contribute for next year that really weren't in our original 23 multiyear guide. So there are going to be puts and takes there, but we do think '23 is a more positive environment. In terms of launching Element Aim into Europe, no, there are still plenty of places, plenty of pockets and plenty of confident well-performing businesses in Europe. It's not like everything is shutting down. So I think we're having good response on Element AIM. Candidly, our execution was a little bit slower and exacerbated by some of these concerns that we've pointed out. We had slower execution getting Element AIM internationalized in terms of languages in terms of marketing materials in different languages, installation, training materials, training videos, those types of things. So we have to own some of that. Some of that was execution and some of that's economy. So I'm not trying to blame the whole change in '22 on the economy some of that is execution. But I think we've got it right now, just took an extra month or 2 to get it right. And unfortunately, you can't get those months or 2 back in terms of making the contribution in '22, but they will contribute in '23 now that we've got them right.

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

  Q. Thank you so much.

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

  A. You're welcome.

- **Operator - -**

  A. Thank you. Thus we move on to David Westenberg with Piper Semler.

- **Operator - -**

  A. Sorry if there's any cut out, I am calling internationally right now. So I just wanted to touch on that European point. Like I definitely appreciate the structural issues in Europe just from a fundamental macro standpoint, we're all hearing it across the different companies. But how can we feel comfortable that you continue to have a structural sound strategy there that there's nothing maybe Heska specific and if there's anything qualitatively you can point to or even quantitatively, I did see instruments that do better than expected on an organic basis versus recorded basis, I mean is that post some of that evidence that you really are executing there, and it really is just a matter of the macro just improving.

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

  A. Yes. So I look at broad-based, if you see broad-based slowdown, not executional, I think you have to believe that, right? The teams didn't get up 30 days later and just forget how to do their job 5% or 10% less well, right? And so I think that's real. There's a lot of noise, obviously, with Forex and everybody can do math. I'm not going to point to that too much, but it's real. Interest rates are real. Those affect ability for people to buy things like ultrasound, digital x-ray machines kind of capital investments so again, I don't think they're Heska skill specific. I would point out, too, I may use broad numbers, but let's just say our international business is 35%. We're concentrated in Germany s o a bigger portion of our international is concentrated in Germany. And I do think the Ukraine effect, certainly, the gas inflation and in securities around that are affecting German society more than, say, Spain, France and some of the other countries. I do think they've secured enough gas. We're hearing some positives from our German Board member and some other touch points. But I really think we're about in line with what you're seeing economically, probably a little bit more specific to Heska because we're more concentrated in Germany, which has had a more difficult economic news cycle.

- **Operator - -**

  A. Got it. And then let's turn our attention back to the U.S. Just a 2-parter, and then I'll move on there. So how do we feel comfortable about market share? I know I mean should we continue to look at that consumables growth number and see that 11% be excited about that and you continue to be a market share gainer. And then as you're layering on Element AIM, there was a lot of commentary about the slowness and that affecting your guidance. Is Element AIM in the U.S. operating as expected? I think I'm hogging cushions by doing those 2 partners so I'll stop there.

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

  A. So with Element AIM, we're not disappointed. We're not disappointed with the trends. We're not disappointed with demand. We're a little bit disappointed with our speed of execution. So I would point to a couple of touch points on Element AIM. Clinically, it's performing wonderfully, internally, I think our teams would say it's probably the best product launch in terms of performance that we've done. And so when you have a product that's performing well, remember, we invented it, designed it, manufactured it, deployed it, consumables, supply chain, all of these things, and I think it's gone extraordinarily well. And then customers are thrilled with it. Where could we have done better in '22? We have a strength in corporate accounts and we had demand from hospitals and corporate accounts, but we didn't get out ahead of contracting and corporate accounts. And what I mean by that is when a hospital that's owned by a large corporation says, I really want one of these new element aims, and it's not on their contract and it's not in their system we have to take a step back, and we have to go through their process. We have to convince now the Chief Medical Officer to sign off on it. Now finance has to add the SKUs, Legal has to review the addition and then it has to get pushed down to the regional managers for approval, and then the hospitals can be serviced. And we didn't really accomplish that. We're roughly 90% of our corporates are now under contract with Element AIM added so that their hospital demand can be served and installed. But again, we probably lost a couple 2, 3 months. That process has taken a little bit longer with some corporates more than others, but in general and that's probably 50% of the initial target Element AIM customers because those tend to be some of the larger, bigger users, bigger hospitals. So those things are in the number as well. But I'm thrilled with Element AIM because it performs well. It solves a problem that veterinarians and technicians love to have solved and it performs really well like people who have it are thrilled. And we've different utilization levels we've got a handful of customers that are 20,000, 25,000 in consumables utilization this year and then a handful of customers who are just now getting the feet under them. So long term, I think it's going to be a great contributor. And I think it's a successful product launch, just a little bit slower than we'd hoped.

- **Operator - -**

  A. Thank you.

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

  A. You're wecome.

- **Operator - -**

  A. Move on to Elliot Wilbur with Raymond James.

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

  Q. Thanks, good morning. Kevin, I wanted to go back and ask a question around vet clinic visit trends. I think last conference call, you and Catherine had highlighted the fact that you believe that the company's delta or exposure to the percentage and visit declines was something on the order of 0.5 to 0.75 or helping in that range. And I'm just wondering if that is similar to the experience that occurred in the third quarter and then maybe just bigger picture thoughts in terms of the overall trend in that number. I mean there had been expectations for recovery by year-end that seems somewhat unlikely at this point. But as we shift our thinking towards 2023, what are you thinking about in terms of a potential inflection point in that number, so much of the industry narrative, I guess, has revolved around the idea that it's largely capacity driven, but it seems like there's other factors that are increasingly beginning to weigh on the return to the normalization in terms of clinic visit trends. So just maybe get or somebody get some high-level perspective on that thought. Then I have a follow-up as well, but I'll stop there for a moment.

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

  A. Yes, Elliott, I'll try and riff a little bit and I'll keep it reasonably short. Yes, if that visits are off 4 and in terms of visits, we're seeing unit volume in the negative 3, negative 2.5. And I think those trends are largely in place so when vet visits are off 3, 2.5, we're not capturing necessarily 100% of them, and it's not a direct link, so it's not going to be a ratio where you can say, okay, the visits are of 2.5 apply 0.75 multiple to it and we'll get exactly what unit volumes are going to be because I think diagnostics seem to be holding up a little bit better. I think spending per visit is a reasonably good indicator that diagnostics are holding up a little bit better than vet visits. We think the trend is good but again, 30, 60, 90 days in these snapshots, they're helpful, but they're not precise. In terms of normalizing, I think that's a super important word. There's still a ton of noise in the year-over-year comparisons even on labor constraints and some of those things. And so we're watching it, but people tend to get comfortable and they tend to do better with constraints once they normalize, once they get more comfortable with it. So vet clinics are adjusting, pet owners are adjusting everybody is adjusting and there's still an awful lot of noise on year-over-year in terms of vet visits and things like that. So I think it's a little bit early to say it's all clear, but I think the trend is definitely not negative 4. I think we're under negative 3 at this point, probably somewhere in the 2s. And maybe by the beginning of next year, we start getting back to growth in the, I don't know, maybe second, third quarter of next year. It's a trend.

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

  Q. Okay. And just following up on some of your comments earlier with respect to some of the dynamics you're seeing in the EU market on the capital equipment or larger dollar ticket item purchasing patterns. Just wanted to ask basically a similar question in terms of what you may be seeing in the U.S. are with higher inflation, and higher cost of financing, greater macroeconomic uncertainty, how much is that negatively impacting capital equipment decisions on the part of independent vets and some of the larger corporates, thanks.

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

  A. Catherine, I think we had a great fourth quarter and third quarter last year in imaging. And so I don't think we're looking certainly for growth over that with the headwinds that we pointed out. I don't think any of our numbers that we're calling out are kind of cliff events. We see 1 million here, 0.5 million there, 1 million here, 0.5 million there. And so what I mean by that is ultrasound in Canada might struggle where digital radiography might be doing okay. Going into the November, December selling season for capital equipment in the U.S. tends to be tax driven just in terms of Section 179 accelerated depreciation and some of those things. But again, I don't see it as a cliff event, but I definitely see it as cautious. I think it's logical for people to see that that it's more expensive to finance it and capital equipment has a higher ticket item upfront. I think this requires a little bit more confidence. So we hear that from the sales team, and I think that's real. Catherine, do you have any additional color on that?

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

  A. No, I agree. I think the last half of last year for especially the U.S. business and even Europe into Q4 from an imaging standpoint was pretty high further record revenue for Heska in that regard. So the full year guidance didn't necessarily improve step up. And I think you're right that based on what we're seeing, there are certain headwinds that we're just being more cautious about given trending through the third quarter.

- **Operator - -**

  A. Is there anything further Mr. Wilbur? We'll move on to Ben Haynor with Alliance Global Partners.

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

  Q. Congrats on the clearance of the True Rapid hardware test. And can you remind us how you plan to bundle that in the U.S. or what kind of the commercialization plan is here?

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

  A. Yes. You followed the company for a long time so that's been one of my White Whales to get heartworm approved. And so that October 20, that was a big day. So in terms of getting into that market, we exited heartworm several years ago and getting back into it with a wonderfully performing test and good margin also comes at a good time for us because we manufacture a very nice heartworm preventative. And so the Merck cells that heartworm preventative Tri-Heart is a Heska product. And we also have the ability to market it under our own brand. And we think that a test and treat is good. We think that a super high-performing test. We think we have the highest performing test on the market at a very aggressive price can get some market share. And so we love the rapids business it's just it's got a moat around it and part of that moat is regulatory. And the hardest thing to do is to get heartworm tissue samples, the natural way, and it's just taken many years to get there. So yes, test and treat And then also, there are thousands of shelters in the United States that every time they take a pet in a heartworm test is required heartwarm test required on the way out. And then, of course, Heartwarm preventative to make sure that they don't affect the whole population within the shelter. So we see just a number of really good markets there.

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

  Q. And well, I guess the question is, will those be kind of sold as more of a one-off type product rather than say, hey, include the true rapid in your bottling extended with (inaudible) for another 6 years?

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

  A. Absolutely, we will approach our subscriber customers and make it part of our bundle. I think everybody understands the power of a bundle and the power of having every leg of the stool and having a rapids business, I think, is an important piece of that. So yes, we'll definitely be going to market with our own customers, corporate accounts, same thing, shelters. And these they don't necessarily tend to be one-off they tend to be in bulk. The other thing is being ready for the main heartworm selling season, which tends to be spring is important as well. And obviously, we missed that in 2022 and obviously, we won't miss that in 2023 so kind of a year-over-year comparison, that's a nice positive for us as well.

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

  Q. Okay. That's helpful. And then can you discuss the AI-powered aspects of the PIM system here?

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

  A. Yes. So there are 2 things that are really happening in PIMs, well, maybe 3, but there's just a general upgrade cycle because of mobile and cloud deployment, the ability to run on touchscreens, mobile phones and cloud to upgrade, update all those types of things. So I'll just call that cloud mobile architecture. And I think that's going to cause almost all legacy systems in the veterinary space to go through an upgrade cycle. The second thing is the AI piece, the predictive medicine piece, and that does a number of things that are super helpful. For instance, based on age, species, weight breed, all of those types of things and presenting conditions, there are clearly certain disease processes that are going to be more prevalent in some of those combinations than others. And the ability for the AI then to predict and recommend the next steps in terms of the next diagnostic and then eventually recommend the next steps in terms of the pharmaceutical and even the diet is super important. In addition to that, the AI has the ability to speed up workflow, a tremendous amount. You're starting to see deployments in things like x-ray, for instance, where the AI is able to pick up with an unbelievably good recognition rate, a lot of pathology off of X-rays point those out and speed up workflow and improve the diagnostics and then recommend the next steps. And so those next steps might be an ultrasound. The ultrasound next steps might be the final aspect goes on a slide and it goes to our HeskaView telecytology business. So all of those things, AI will be very helpful for. And one of the things that we find and we share this with our industry peers, the breakdown of next steps requires that every veterinarian have the latest information from the latest papers on what the diagnostics reflects to. And a lot of times, there's a breakdown somewhere in that process and all of the testing that clinically should be done doesn't necessarily always get done. And I think AI will support that decision-making process and make sure that all the testing that should be done is getting done. So it's a super big revolution, I think it's going to also help tremendously with labor constraints. It will speed up workflow quite a bit.

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

  Q. And on that should be done that gets to be done or it becomes done because the AI suggested it. Does that also do you think help with some of these veterinarians who may not be the most comfortable on selling whatever the next diagnostic and the chain might be, does it make it easier for them to because we should run this that and the other thing to the pet owner in your view?

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

  A. Absolutely. Look, we're all creatures of habit and if our habit has a hole in it, we don't know, it's probably a blind spot. Look, veterinarians want to do the best medicine they can, and then they want to present Level A medicine, Level B medicine, level C medicine within the constraints of the finances of the pet family. The AI is going to give them a tremendous amount of information to do that without falling into those holes, those blind spots. And remember, there's a great amount of variability in the age and the training of veterinarians globally. And so certain markets will do more testing of certain things and certain markets will do far less testing. And it's not because the patient species breed wait age, all of those types of things are different. Spanish dogs and cats because they speak Spanish, probably don't have different testing needs than German dogs who speak German. And so some of those holes that you'll find are just that universal global best practices aren't necessarily making its way into each of those geographic markets. And so I do think that the AI and then the easy to deploy and upgrade and update the AI capabilities via a cloud architecture will be super compelling, and they're just literally thousands and thousands of legacy systems out there that are totally incapable of this, and I think it's a big opportunity.

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

  Q. Okay. That's very helpful. That's it for me.

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

  A. Thank you.

- **Operator - -**

  A. Thank you. (Operator Instructions) Next, we'll move on to Erin Wright with Morgan Stanley.

- **Erin Elizabeth Wilson Wright - Morgan Stanley, Research Division - Equity Analyst**

  Q. Great, thanks. Where are you now in terms of the installed base for Element AIM and how should we be thinking about that in terms of your goal for the year as well as heading into 2023 in terms of the Element AIM strategy and installed base there, thanks.

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

  A. Yes. So Element AIM will come in below our 500 target for the year. I think we've called out the discrete reasons, mostly delays in execution in getting to market in Europe, 30- to 60-day delays in some of those markets from what our plan was and then also in getting added to the corporate accounts, which again, we've accomplished that as of November, but we can't get the full calendar back. Going into next year, I think both of those things are in place. I think supply chains in place, logistics in place, localization languages in place. So I think we're in a pretty good place. We're not remediating quality or performance issues the product is performing wonderfully. We've just been a little bit slower on the draw and getting the product out to our own people and getting it executed on our own corporate accounts. But I think those are largely behind us. So I think we're in a pretty good place. Our M&A number is in our guide for the balance of the year. And so I think we've communicated what that looks like for '22, and I think '23 looks better.

- **Erin Elizabeth Wilson Wright - Morgan Stanley, Research Division - Equity Analyst**

Q. And what are some levers that you can pull if fundamental trends don't get better from here either from a macro perspective or just in Europe, for instance? And how are you thinking about your visibility on growth now into 2023 in light of these dynamics, thanks?

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

  A. Yes. No, that's a great question. Again, you control what you can control. And so product launches are critical and it's a reasonably weak answer, Erin, but it's real. If you're late in '22, you're late, not you failed and you're ready for '23, the things that you didn't capture financial economics in '22 become positive in '23, they, by definition, become that incremental contributor and I think we've got a handful of those. So we were maybe a little optimistic on the calendar, but not the end result and we lost 30 days here and 60 days there in various different things. But going into '23, those things are secured. I called out Rapids heartworm in North America. We hope to have the heartworm approval in time, at least for the late selling season through the summer and we didn't get it from USDA, but we did secure it on October 20th, and we'll have it going into the next selling season in the spring. So things like that are growth drivers that we just didn't capture in '22 that we're confident we'll capture in '23 because we've hurdled the barriers. So I think that answers the question. I've called out a couple of those on the call, not all of them.

- **Erin Elizabeth Wilson Wright - Morgan Stanley, Research Division - Equity Analyst**

  Q. Thanks so much.

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

  A. You're welcome.

- **Operator - -**

  A. Thank you. And we'll take Mr. James Sidoti with Sidoti & Company.

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

  Q. Kevin, can you talk a little bit about the LightDeck acquisition, why you made it now and what do you think the impact would be on gross margin and operating margin?

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

  A. I'll take the strategy piece first. LightDeck is an extraordinary technology. We began to work with them and that's our Element i+ platform. And it's just extremely scalable and when I say scalable, the menu is scalable, the performance, the ability to put multiplex tests on it. So it does immunoassay tests have been very well received, but we wanted to scale it. We want thousands of them in the field, not hundreds, and we wanted to accelerate product development. We made an investment in a cancer screen our new cue cancer screen and so that runs on our LightDeck developed and manufactured Element i+ platform. And so that investment, taking that in-house allows us to go faster and allows us to go at a much bigger scale. We think the cancer screen is going to be a very, very large business. We think the performance, we think the market that it serves, a cancer test that serves a $50 or below tests that can give you a cancer screen in minutes at the point of care we think that's a winner. And the veterinarians seem to agree. So for instance, on our last webinar, we attracted 1,900 registrants, 61% of those said they were very likely or likely to do cancer screening in their practice and another 28% said they weren't sure. We had to lap, we're not quite sure what the other 11% are thinking, but that's just one webinar that was conducted about a month ago. And so there's clearly huge demand for taking it in-house and being the technology owner of those things, the intellectual property and then the ability to make thousands of analyzers and millions of tests at scale. And the timing was really good. The BARDA U.S. government funded had also recently invested about $35 million into a very high capacity, super modern, super automated facility that's able to reach FDA and USDA level manufacturing. And it happens to be in Longmont, Colorado, which is about 30 minutes from our corporate headquarters. So it's just the fits across the board. We think that, that product platform can be a huge franchise builder. We think it's super unique and we think it's going to be a halo product for us so a great investment.

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

  A. Yes, I can take the 2023 question, Jim. Obviously, we haven't provided much detail around the impact to 2023, just in general, as we'll update our guide for 2020 during our fourth quarter call. But given that we are acquiring a not yet online, rather significant manufacturing facility with great capabilities sometime in 2023, which is the data is not yet definitive. We do believe it will be dilutive to operating margin and adjusted EBITDA margin in the near term as we start to scale that facility and as Kevin mentioned, coupled with the timing of the cancer screening and monitoring test as well will impact the amount of dilution and the extent to how long we would expect that. So we'll have more detail in February.

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

  Q. My question was actually more of the longer-term impact on gross margin. When everything is running there at capacity, what do you think a good target is for Heska's gross margin?

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

  A. I think it's too soon for us to communicate that on a long-term basis at this point.

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

  Q. Okay. But I assume you do think it will be fairly accretive to where you are now, this acquisition?

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

A. Yes. Over a long period of time, for sure.

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

  Q. Thank you

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

  A. Yes. And one point on that, Jim, and thanks for the question. When we say that we're in a build phase and we're now transitioning into scale, the ability to scale something like an Element i+ does 2 things. Just in the last couple of years, we've launched Element AIM, which is a fully proprietary Heska-owned invention, and we make it and it has great margin profiles, especially as scale increases. And we've done the same thing now with Element i+. Traditionally, point of care is chemistry hematology. Some of these newer products are the products of the future, they're differentiators. I think Heska can claim to have the most interesting, innovative and possibly influential point-of-care portfolio. So we do a great job in just a traditional chemistry hematology piece, but I think the future is going to be one on new testing, things like cancer screening and things like Element AIM. So owning those as Heska-owned inventions and then having control of our destiny and the scalability and just the inherent value of assembling those assets, I think, is extraordinary. So yes, it will be accretive to margins, but it's also much more than that.

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

  Q. Thank you.

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

  A. You're welcome.

- **Operator - -**

  A. Well, there are no further questions, I'd like to turn the conference back over to you, Mr. Wilson, for any additional or closing remarks.

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

  A. Hi, thank you. Thanks, operator. Thank you to everybody who joined the call. Go vote I guess it's a voting day, including you, David, you're international, but I hope you were able to vote. So we'll look forward to updating you on our full year and our '23 guide here on our next call. So until then, be well, stay safe and yes, go vote. Thanks. Bye-bye.

- **Operator - -**

  A. Thank you. And that does conclude our teleconference today. We do appreciate your participation. You may now disconnect.