Heska Corporation

Analyst/Investor Day

May 15, 2018

CORPORATE PARTICIPANTS

Kevin Wilson, *CEO & President*

Nancy Wisnewski, *Executive Vice President, Diagnostic Operations & Product Development*

Steve Eyl, *Executive Vice President, Global Sales & Marketing*

Catherine Grassman, *Vice President, Chief Accounting Officer*

Jon Aagaard, *Director, Investor Relations*

Jason Aroesty, *Executive Vice President, International Diagnostics*

PRESENTATION

Jon Aagaard:

Good morning everyone. I think we've got the majority of folks here, so we're going to get going. Welcome to Heska's Investor and Analyst Day 2018. We really appreciate you being here. I'm Jon Aagaard, Director of Investor Relations. Last time we did this, some of you may remember, it was 2013. The stock was trading around 5 and Heska was about 3% market share, so, some things have changed. We're excited to talk to you about that, about Act 1, and what is coming in Act 2 of Heska's story.

To do so, with us today, seated here in front from right to left is Steve Eyl. He's Executive Vice President, Global Marketing and Sales. We've got Nancy Wisnewski, who is Executive Vice President, Diagnostic Operations and Product Development. We have Mr. Jason Aroesty, Executive Vice President, International Diagnostics, and Ms Catherine Grassman, Vice President, Chief Accounting Officer and Controller.

Before we begin, of course I need to provide our forward-looking statement. This document and presentation, verbal or written, contains or incorporates by reference forward-looking statements regarding Heska Corporation and its affiliates, including projections, estimates, forecasts plans and objectives. Although management believes that expectations reflected in such forward-looking statements are reasonable, no assurance can be given that such expectations will prove to be correct. In addition, these statements are subject to certain risks, uncertainties and other assumptions that are difficult to predict and may be beyond our control. If one or more of these risks or uncertainties materialize or if underlying assumptions prove incorrect, Heska's actual results may vary materially from what management anticipated, estimated, projected or expected. The key risks factors that may have direct bearing on Heska's results of operations and financial condition are described in detail in Heska's periodic reports, most recently filed with the Securities and Exchange Commission, and investors are encouraged

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Okay, now in terms of order of events and agenda, Mr. Wilson, our CEO and President, whom most of you know, will kick things off this morning, and he will facilitate the discussion with the Executives seated up front here. We'll have time built in at the end for Q&A so please keep the questions on hold until the end. And we hope to leave you very excited and confident in what is to come here in Act 2.

By way of housekeeping, we've posted this presentation on the IR page at Heska.com, and we can provide additional copies upon request. WiFi is here. Convene Meeting Centers, I believe, or Convention Center's password, lowercase meetings. Signage around for that as well.

With that, I'm going to turn it over to Kevin Wilson, Heska's Chief Executive Officer and President. Kevin, the floor is yours.

Kevin Wilson:

Thanks, Jon. … (audio dropout) …

In all seriousness, thank you. I'm always flattered. I'm always humbled that folks like you spend some time following Heska, reporting to shareholders, doing work on what we do. We're excited about what we do. We think it's important. We think it's important for pets. Pets are super important to kids, super important to families. It's important to veterinarians. It's important to their families, important to our employees. It's important to their families. It's important to shareholders and it's important to their families. So, we take it pretty seriously and we really thank you for doing that.

We went through our disclosures. Obviously a key part of any presentation, but risk factors are a serious thing. This one came across my desk a couple of weeks ago. We didn't really know what to do with it.

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We're not sure if we should be exploring a mechanical veterinary business. We're not sure if our pets are going to just be displaced. It's a very concerning thing. Mr. Bezos is displacing everybody; he might as well displace my border collies. So, I went home and I asked them, "What do you think? Is it a risk factor? Is it competition? Should we have it on the product road map?" They weren't really very impressed. They said, "Nah, not so much. We're way cuter. Don't worry about it."

… (audio dropout) …

… were negative. Assets were $93 million, equity was 47. Importantly, our point-of-care laboratory diagnostics market share was roughly 3%. So, we rolled out a plan to get that moving in the right direction and as we concluded 2017, we had seen $110 a share for closing price; revenue had risen to $129 million; gross margin in the five years had expanded over 6 points; operating margin had gone from negative to positive and income, EPS, assets and equity all improved. Importantly also, our point-of-care laboratory market share had risen to roughly 10%. So, I think we actually had a very, very good period during what we call our first act.

The first part of that process, and I think it's instructive to go through each of those steps quickly, I won't rehash it for hours and hours but I do think the context is very important.

The first part of that process was to get product right. We think today that we have the best and newest family in point-of-care laboratory diagnostics, and part of that ability to say that is that virtually everything that we do in that space is new since 2013. So, in the second half of 2013, we added the Element POC. We'd been out of the blood gases space, electrolytes and metabolites, and the Element POC was added in the second half of 2013. Closely followed by that, in 2014, we added eWraps to our dry chemistry. We believe that dry chemistry is the best method of operation to do chemistry in the space, and what we lacked at the time though was the ability to very easily run panels—presurgical panels, comprehensive panels—and that was a major limiter for us in acquiring customers from our largest competitor. So, in the first half of 2014 we were able to launched preformed panels—we call them eWraps—for presurgical and comprehensive panels. Those panels represent the vast majority, 90+%, of sales of chemistry panels, so that was a very important innovation to get to the market.

Followed closely on that, we upgraded our hematology product. At the time, it was limited to a three-part hematology. We were able to add a five-part hematology that uses laser and impedance as a method. We believe those are the best and accepted best methods and the Element HT5 was rolled out in the first half of 2015, and has just been very, very well accepted.

The first half of 2016 then, we followed that up with the Element i which is an immunodiagnostics platform, going T4, TSH, cortisol and now bio acids. It is the only product in the space that does TSH, which is a critical parameter for thyroid function in dogs, which is a top three to five measurement that people are looking for, especially in aging dogs, so that's a very good product for us as well.

Then just recently in the first half of 2018, we launched the Element COAG, which is a new product line for us as well that does coagulation and blood typing. That's gone extremely well. We'll talk about that in just a moment.

While adding that, we also had to attack the challenge of practice management integration. Today we integrate with 80% to 90% of practice management solutions, including those with direct competitors. The video that you're seeing is just showing the AVImark and ImproMed IDEXX Cornerstone and ezyVet. Between those products that represents 80% to 90% of the market.

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Integration with our products for two-way communication between those practice management solutions is in place and is working very well, and that competitive moat has been degraded and we think we compete very, very effectively in terms of integration, especially with the Henry Schein products.

The second part of that integration has always been how do you link point-of-care diagnostics results with reference lab diagnostic results? To date there had only been one player that had both point-of-care and reference lab that could then integrate those into one unified record, regardless of where you ran the study, and just recently, the Henry Schein properties have launched what's called Access Q, so I'll let you …

(Video presentation)

… (audio dropout) …

getting product right. Axis-Q is an innovation by Henry Schein. Henry Schein has over 50% usage in practice management solutions with their products, most AVImark and ImproMed, and the ability for Heska to communicate with that two-way and then also then integrate with reference labs, Antech and IDEXX reference labs, interestingly that's important to a large percentage of our customers. You'll see that Heska subscribers, roughly 36% of them use IDEXX as a reference lab, but use Heska as their point-of-care solution. That's an important innovation. That's one that hasn't been done vertically and internally, but it's been done in partnership with Henry Schein, so they did a great job with that.

We also added in 2013 an imaging product line, which is digital radiography and ultrasound. It is a great product line. We're very happy to own it; it's a great property. I'll let you just hear what our customers have to say about it.

(Video presentation)

I always like to hear from customers because ultimately we sometimes forget about that. They're just normal veterinarians. They run small businesses, and when you can delight your customer with technology like imaging, those customers then are more likely to be delighted by things like point-of-care plus diagnostics. So, we're thrilled with the performance of the imaging business and our ability to delight those customers so that they're more apt to buy other Heska products.

Moving on, our Heska team. We had to get the team right. Today we stand at 335 employees. We have two reportable segments. The first is our OVP segment, Vaccines and Pharmaceuticals, which is out of Des Moines, Iowa. The second is our Core Companion Animal segment, which is primarily located at our Loveland, Colorado location.

The Des Moines location is 125 full-time employees. Their focus is on vaccine and pharmaceuticals. Those 125 folks generate roughly $19 million in revenue for the OVP segment, but I'm going to take a step back and chase this one a little bit and explain what their impact is on the rest of the business; I think it's important to understand.

The activities in Des Moines, because it's a USDA approved regulated facility, they produce the vaccines and biologicals and pharmaceuticals primarily on a contract manufacturing basis for folks like Elanco, Bayer, Merck, Virbac are the customers that produce products in that facility. But they also in that Des Moines facility produce Tri-Heart which is a heartworm treatment. It's roughly a $15 million a year franchise for Heska. It's a Heska product manufactured under Merck's label and sold by the Merck sales

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force, not Heska, but that $15 million shows up in the Core Companion Animal business under our PVD section of Core Companion Animal.

The other thing that they produce in that Des Moines facility is Allercept immunotherapy and we'll discuss that a little bit more later, but that is roughly a $7 million business line for Heska, $5 million of which is the immunotherapy that is produced to treat or to provide therapy for allergy, and that comes out of the Des Moines facility as well.

Then those folks in Des Moines also provide technology and logistics for pack and shipment for the products that we ship directly to customers. They receive the technology and do the intake testing for quality control and those types of things. It's a very large facility. I think it's about 168,000 square feet. They do a great job.

I think it was just good to provide a little bit of context to what actually happens out in that Des Moines facility. It's not just OVP, but the primary revenues that get reported related to that facility are in fact OVC.

Our Loveland, Colorado team represents about 210 full-time employees. That is primarily dedicated to the Core Companion Animal segment which generates $120 million in revenue at roughly 44% to 49% gross margins. All of the normal functions that you would expect would occur out of the Loveland office, so marketing and inside sales with the medical technical consulting team to handle medical technical questions for our customers when they call in. Technical Support happens in Loveland, Accounting and Finance, Analytics and Subscription Management and other corporate functions happen in that facility.

Part of that 210 full-time employees through the Loveland location then would be our Field Commercial Team. Our Field Commercial Team is roughly 85 people, 45 of which are in point-of-care laboratory, 23 of which are in Imaging, 15 of which are Field Customer Team—they would be technical people that would go in and do training and installs and things like that—and then Corporate Sales and Allergy represent the balance.

So, that's the breakdown, and we'll talk about our expansion in that later, but that's the baseline that we're at today.

Moving on to costs and getting those under control is just a matter of doing lots of little things a little bit better than we were. We've been able to raise our gross margin on test supplies to the 60% to 75% range, so that is the highest gross margin and most profitable part of our business is test consumables. It's something that we focus on a great deal. Our test costs are fixed, so as we grow and as we realize price, that does help the company's gross margins improve over time, and that includes what we call a tail. If we make transitions from certain products to new products, we have access to those consumables, generally for five, sometimes longer years in terms of a transition period at those fixed costs. That's an important thing to understand just strategically is we have the ability to innovate without harming our existing revenue and gross margin stream.

We streamlined our reset collections. I'll talk to you about how we structure our subscriptions and how we removed friction from the process, which certainly helps with cost, and we have a very high leverage on our cost basis. You'll notice in our performance that in quarters, generally the fourth quarter, when we do much higher revenues, you'll see the operating margin scale substantially. That's a nice indicator, at least in my mind, that the cost structure is still very scalable and there's still a fair amount of leverage in that cost basis.

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Then we focus on model. Model is our reset subscription, so I'm going to focus this portion on point-of-care laboratory diagnostics. Our reset subscription, the idea behind it was to get off of the train where we're selling equipment on a five-year cycle, but rather we're placing assets in clinics and the folks in those clinics are using those assets to put dog and cat blood through our assets and then we both benefit, but it's subscription as opposed to selling and transferring the asset off of our balance sheet.

The program works very well. It's super simple. It's pay less, get more, no tricks. We try and keep it very simple for our customers, and it starts out with the fact that it's hard to be a veterinarian. They work a lot of hours, 56 hours a week for a practice owner. Salary is $150,000 to $200,000. Debit is very high coming out of college and retirement is questionable. Twenty percent of their profit is in diagnostics, and it's great to be the guy selling them diagnostics. They have to buy the analyzer, they have to pay to warranty the analyzer, they pay a lot for the test and they have to pay unlimited price increases whenever the company wants. The Heska reset fixes those problems.

The first step is we provide free technology. There's no front up capital; they simply select the analyzer. There's no warranty because we own the analyzer. If it breaks we just send them a new one. Then in terms of fair pricing, the starting price of the program is super important as a veterinarian, so we have super fair, transparent pricing. There are no rebates, no free product, no points to be used. It's very, very simple. Then we protect the whole program with price protection. Everybody is used to teaser prices that get raised once you're in on a program; price protection solves that problem for the veterinarian, and for Heska. We promise that your panels will go up 4% a year. That's our reset guarantee in terms of price protection, so they can count on not receiving two, three price increases and not knowing what that technology is going to cost them in the future.

When you add all that together, the fair low starting price and then the compounding of price increases over years, what our customers find is that our savings grows because of the compounding. Our lower starting price and then our 4% price increases they can count on results in real world savings. So when you look at what a real clinic does, just a normal, average clinic 20 days a month running normal, average volume, by switching to the Heska reset program and using their own data, these folks save a legitimate amount of money and it matters to them.

What do they do with that money? They can make testing more accessible to clients. They can reinvest it in new diagnostics. They can put that profitability in their pocket and give themselves a raise. The point is is they can run their business, it's their choice. Most of our customers will do a little bit of all three of those things; they'll provide more treatment, they'll provide better access to treatment after the diagnostics, they'll pay themselves a little bit more, they'll do all of those things. But the bottom line is those extra funds matter to them and their pretty significant when you put it in the context of what the average veterinarian is making compared to what they're doing for their job. Remember, 20% of their revenue and profitability is related to this segment, so it matters. It matters a lot to them that they get it right and that's really Heska's job is to explain to them how they're not getting it right but they can very easily get it right with the Heska reset subscription.

Let's just talk about just roughly what is it when we say subscription. It's really simple. When actually even use this word in the subscription agreement. There's a mutual promise and it's very simple. Heska agrees to provide the four necessary reset guarantees. We've had competitive responses. The competitor has a vote. Every day they always vote no, and they have a competitive response, but we've yet to see anybody have a competitive response that provides all four guarantees.

We've seen mixes of free analyzers or free warranty, or free analyzers and warranty with higher test price. We've seen mixes where you start out with a free analyzer and lower test pricing but there's no

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guarantee the test pricing won't go up in the future. We've really not seen programs from the competition that commits to all four of these things, and I think they're very difficult to commit to, so we'll talk a little bit about that.

We provide the necessary four reset guarantees. In return for that, the veterinarian agrees to provide us what we don't have; we don't have dog and cat blood. They have dogs and cats coming through that need diagnostics. Roughly 15% of the dogs and cats they see are going to need a diagnostic and we need them to then use our technology and run our tests on our analyzers, and so that's their part of the problem. Then we both agree to do that for six years, and if we both do that for six years then Heska's the best diagnostics. They get better value which leaves them more money to provide treatment, care, diet, pharmaceuticals, and those types of things. There's less financial euthanasia, meaning customers run out of money less often that result in financial euthanasia, and that's a real issue in veterinary medicine. There's no limitless pocket in anybody. These folks come in, they've got mortgages, they've got car payments, they've got kids and now their dog is sick and they want to get … (audio dropout) …

… then you do the same thing for hematology. We call chemistry and hematology a core lab. Virtually all of our placements include both chemistry and hematology. Not all of them but it is almost universal that they'll go together.

The third section is we have just what we'll call just kind of ancillary analyzers for immunodiagnostics, coagulation, blood gases, those other three, and those have different desirability in different clinics, depending on how they practice medicine. So, specialty hospitals, for instance, may want blood gases, so they would add an Element POC and some folks may want to do more thyroid testing, they would add an Element i. They simply pick that which rolls up then to their monthly minimum commitment.

Keys to the program, we went over the mutual promise that we both make to each other. This is an important distinction. The assets are retained by Heska. We manage these assets as a portfolio of products veterinarians counters. We're not motivated to swap things out based on a lease schedule terminating. We're not motivated to go in every five years and swap out the whole suite. We manage it based on what the latest technology is and that whole portfolio gets managed.

What I mean by that is think about it more like commercial real estate or apartment management. What we want to do is we want to continue to improve the commercial real estate or apartment management, but that doesn't mean knocking it down every five years and building new ones. We want to own those assets and those assets will have different useful lives to the veterinarian based on their actual usage. That's a very important feature, the fact that we keep it. It allows us to manage that portfolio. We can launch new products. Of the three or four analyzers that are on the counter, we might launch one new product, upgrade that new product and extend the whole contract for 72 months from the date of the upgrade. Because one product segment has received an upgrade doesn't mean the other three products need to (inaudible).

These auto renew, so at the end of their six-year term, unless they're cancelled, they auto renew for two years. The majority of these come with personal guarantees. So we make a promise to the veterinarian. The veterinarian is usually very comfortable making a personal promise to us. … (audio dropout) …

The way the program works is at the beginning of the month we generally sweep out of their bank account their monthly payment. For illustration, let's just say their monthly payment is 11 … (audio dropout) …

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At the beginning of the month we sweep $1,100 out of there and let's say they receive a $1,000 credit against supplies. They order supplies against that credit during the month. If they go over that, say they go to $1,400 in a month, the next month we sweep $1,400 out of their account the first day of the month and they have a $1,000 credit just like they do every month. An important factor just in terms of billing efficiencies, relieving friction.

The second thing that's super important is it aligns inventory usage with actual end user use. There's no reason at the end of a quarter to sell somebody product, there's no reason to give them free supplies to offset higher costs in other parts of your offering, and what that results in, and when you do that type of thing as part of your model, is it results in a channel that's stuffed with inventory. Whether that's in distribution warehouses or whether that's on the shelf at a veterinary clinic, if you have reagents and supplies that are stacking up on your shelves, that's actually not good for anybody. The way our model works is because it's a monthly basis, it aligns that inventory with the actual usage because the veterinarian doesn't get credit for overbuying in one month and buying nothing the next month. It's a very important factor.

Then we have rights of audit and we have prescriptive remedies. We don't want to fight with our customers. We want them to be happy. We love them. There are times when they want to terminate early. We have prescriptive remedies in our agreements for that, and they're up front and the customer understands them, and we'll get to what our rates are and our satisfaction in that regard here shortly.

Those are the keys to the Heska program just in terms of how the program works. Behind the scenes, when we get these, we move into how do we measure that and how do we account of the equipment. For that portion, I'm going to introduce Catherine Grassman who is our Chief Accounting Officer. She's going to walk you through the program description in terms of how we account for the assets when we place them under different types of terms.

Catherine Grassman:

Good morning everyone. Thanks, Kevin.

When I listen to presentations on the reset program, my ears always perk up at the word 'free'. Somebody offers something for free, you're an accountant, nothing's ever free, which means there's applicable accounting guidance that we need to apply.

Clearly we've discussed the commercial significance of the reset program and the success is really commercially. It clearly has had financial success as well, but it introduced some variability into our reported earnings quarter over quarter. What I'd like to do over the next few slides is bifurcate the revenue generated from these programs into two streams; one is instruments and the other consumables, and discuss the variables impacting the instrument revenue and its lack of comparability period over period, maybe demystify the accounting behind it, how we've trended historically up until today, and then talk about how we view, at least from a financial reporting standpoint, from a financial measure, the consumable revenue as a clearer performance indicator of growth.

Factors impacting instrument revenue, the most significant being the contract type mix. Our performance, our reset program subscriptions contain multiple performance obligations. I'm going to try and keep this less accounting, less technical speak, but it's important because it impacts Day 1 revenue significantly, depending on where you fall in the guidance.

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These reset subscriptions effectively have two components to them—well, more than two, but two primary—one being the lease of the asset. When we say we've placed an instrument into a customer's location free, we are effectively leasing them the asset. Various factors within that contract determine whether this is going to be an operating lease or a capital lease. I won't go through all the criteria, but there's four main criteria and two additional criteria for lessors. Our subscription agreements tend to fall into either the operating type lease or a sales type lease.

The effect of that on Day 1 is either a smooth operating lease treatment. It would be a period of month over month or quarter over quarter smooth effect, pretty much a straight line effect. Sales type lease is an immediate up front recognition of revenue. In the subsequent slides, I show you an example showing a quarter of pure operating lease treatment versus pure capital lease treatment.

Other factors impacting instrument revenue include committed subscription value. The larger or the varying number of instruments that are placed will also impact, especially as it relates to the Day 1 revenue recognized as it relates to sales type leases. We also report within our instrument revenue, we still outright sell these assets, similar to our competitors, so those are sold at fair value outside of the subscription contract.

Finally, the last two, in Q1 we noted a variation in instrument revenue due to noncore diagnostic equipment sales, specifically our IV pumps. These are also reported in there and have the ability to impact reported revenue.

Finally, as Kevin mentioned, the ability to go back to our customers as we introduce new instruments into the space such as the COAG in Q1, we might see an increase in revenue related to the capital lease treatment of that particular instrument, but what you don't see is the extension of the entire suite of products over a longer period of time, which is more representative in the consumable revenue growth, which is why we believe that is a better indicator of performance.

There's a lot of numbers on this slide. I'm going to try and simplify this as much as possible. I'm also going to caveat that it's a technical area and while the technicalities are not necessarily important to you, it's important to let you know that I've excluded certain components of the guidance just so we can directionally show the impacts of an operating lease versus a capital lease.

In any given quarter, if we entered into 120 reset subscriptions, if we placed 120 contracts with customers, we placed 2 instruments, the HT5 and the Element EC. We exchanged that for a 60 month term with customer at $1000 monthly payment, the combined costs of the chemistry unit and the HT5 is $10,000. These are all assumptions used in this example. Assuming all subscriptions start on Day 1, for simplicity's sake, that our customers utilize exactly $1000 of supplies credit per month at approximately a 65% gross margin.

So, internal company metrics, we look at committed subscription value period over period. We look at subscription months added. In this example we added 7200 months and $7.2 million for committed subscription value to our base. On Day 1 or in Q1 of an operating lease under this portfolio, we are going to remove the inventory of $1.2 million, so it's $10,000 cost of inventory times 120 reset contract. We're going to increase PP&E by the same amount. This is a balance sheet movement. Then we're going to begin to depreciate those assets over their estimated useful lives, so for the purposes of this example we used 84 months, and that depreciation will go directly to cost of revenue over the term of the contract.

For revenue, you have operating type lease revenue and additional consumable revenue. So, for simplicity's sake we just took the committed subscription value of $7.2 million, which is the $1000 monthly

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payment times 120 customers, times 60 months for the quarter. Twenty times $1000 times three months, so we recorded $360,000 of revenue. Assuming, like I said, that the customer utilizes $1000 worth of product at 65% margin, we're going to also reduce inventory by the cost of the consumables shipped in that quarter, which equates to about $126,000, and we're also going to record the depreciation for the period of $42,857. Day 1 revenue, or Q1 revenue is $360,000 on this portfolio of customers.

So, contrast with sales type subscription. Notice I put a 72-month term on this. I know from a comparability standpoint you'd probably prefer to see a 60 month but term triggers capital lease treatment for us. Utilization, if it's percentage versus a fixed payment, triggers capitalization for us. So a 72-month term is significant in this example because this is one of the triggers in our analysis.

Under the same assumptions, 120 reset subscriptions, 72-month term, $1000 monthly subscription, same cost of goods, same equipment, same example except for because it qualifies for capital lease treatment I now have an upfront Day 1 recognition of revenue. I'm removing this inventory from the balance sheet and I am reporting a receivable, short and long term, in the amount of the revenue that I have recognized. The amount of revenue recognized is determined based on observable sale prices of similar equipment relative to the contract value.

In this example, I used 15%, which is directionally accurate, of a total subscription value recognized on Day 1 and every month thereafter when I sweep that $1000, a portion of it goes to the balance sheet.

The same example as far as the utilization of the consumables, $1000 per month, 65% margin, so with that we decline inventory $1.2 million plus the $126,000 for the consumables, we increase our short and long term receivables for the sales type lease portion. We recognize revenue of $1.296 million for this portfolio based on 15% of the committed subscription value, and then we recognize the consumable revenue at the 65% margin of $360,000. So, very significant.

Historically, looking in Act 1, 2013 to 2018. Twenty-thirteen all the way up to July of 2016, we predominantly entered into operating leases, five-year terms. Our sales folks, just like sales folks do, it's always economically advantageous to a company to have the ability to keep your customers longer, right? What could the market tolerate? The market could tolerate 72 months. So, in July of 2016, we entered into primarily 72-month contracts. Now, under that period of 2013 to 2016 we did have sales types leases but they just weren't a predominant portion of the mix. Starting in July 2016 through the end of the year, we had predominantly sales types capital leases. Naturally, the next question is that was like going forward, right?

I would say internally we expect a mix of the two, and the reason for that is it's dependent on customer. It's independent clinics versus corporate accounts. If you have a fixed minimum payment with a customer and a 72-month term, it generally is a sales type lease. If you have a utilization ie. you need to use 90% of your usage has to come through Heska, that's not a fixed monthly payment. It doesn't address one of the two lessor criteria, and therefore it's an operating lease.

In about three quarters from now when we have ASC 842, the leasing standard, I'm going to update that guidance because while fundamentally the accounting for lessors didn't change, there is a difference that actually changes that treatment which we will have to account for differently.

Okay, so side by side. So, balance sheet comparison side by side, you can see at the beginning a contract date on the upper portion of the slide. Under operating it really is a balance sheet movement from inventory to PP&E, the assets stay on our books. We depreciate them over their estimated useful life, like I said, with the amount of depreciation going to cost of revenue during the term of the contract.

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Sales type lease, we effectively move the inventory off of our balance sheet and replace it with a receivable at the fair value relative to the contract value. At the end of the period we will have depreciated a portion of that asset through cost of revenue and we will have, on the sales type, we will have collected a portion through the monthly payment process.

This is, again, just a side by side. Significant difference in accounting for an operating lease versus a sales type lease. This same example in Q2 looks the same. It looks the same. It's very similar from a ongoing treatment. It's the initial Day 1 recognition that drives the difference.

I know we're holding questions until the end. I have a feeling we'll have questions on this.

Now it's pretty easy to see why the instrument revenue reported under the point-of-care blood diagnostic product line to us is less meaningful than the consumable growth, right? Consumables are not impacted by operating versus capital lease treatment. They are the profitability driver for the business. As noted, we have built-in annual 4% price increases, so if our customers are utilizing that $1000 in Year 1, in Year 2 when they're price goes up, they're going to have to buy more. So, on that $1000 our margin goes up and then anything incremental we also get the bump in revenue, and every year thereafter. So, given the accounting implication on is it an operating lease versus a capital lease, this is why we always point you on the earnings calls, why we look at consumable revenue as an indicator of growth and health of the program.

I think we'll wait for questions until the end on this? Okay.

… (audio dropout) …

Kevin Wilson:

… finish up this section.

… (audio dropout) …

Male Speaker:

Hello? Testing, one, two, one two. (sound check for several minutes)

Kevin Wilson:

Okay, we'll get into the fun stuff for you numbers folks.

What is our foundation? What did we accomplish from a number standpoint? We started 2015—to the end of 2014 we had 300 reset subscriptions. In 2017, we had 1950 which represents 81% of our 2400 active clients. The delta between that number would be legacy customers on the front end, and then as Catherine mentioned we still have customers who want to buy the traditional way. It's not a very large percentage but there are customers who do that.

Our retention rate has been 96.4%. Of the reset departures in two years, so a two-year run rate for both '16 and '17, we had 66 customers depart. Fifty-two of those paid the prescriptive remedies in the

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agreement. Fourteen of those we did not ask to pay that. The majority of the 14 would be things like the veterinarian died. We had that happen a couple of times. Retirement, closing and merging where two clinics who were customers became one clinic, those types of things. It's a very good retention rate.

Our target for 2018 for new subscriptions is 450.

In terms of metrics, you can see the subscriber growth. In '13, '14, '15 you can see it months under subscription. So, Catherine mentioned we count months under subscription. It's an important distinction. Subscribers don't all have 72 months left or 60 months left. As they utilize months, when we put a new subscriber in under a 72-month agreement, that's a net pick-up of 72 months. When somebody has used 30 months of a 60-month agreement, so those '13, '14, '15 (inaudible), 30 months of that 60 months and we place a new Element COAG in there and they renew for 72 months, that's a net pick-up of 42 months. Thirty months were remaining on the original agreement, we extended it to 72 months from today for a (inaudible).

Two ways to grow months under subscription; both are super critical. It's one of the reasons that we don't count analyzer placements. It doesn't really give you a visualization into what the long-term stickiness of that client is. Placing a second or a third analyzer on the same counter doesn't indicate whether or not that customer is going to stay with (inaudible). So, months under subscription is a key metric for us.

Then we also have minimum estimated contract subscription value, CSV. All accounts aren't the same but they do have a minimum. So, when somebody selects two analyzers at, say, $1100 a month, that has a 72-month term, that has a different minimum contract value than somebody who selects three or four analyzers at say $1500 a month for 72 months. So, obviously larger accounts with more analyzer placings gives you a contract subscription value and so we watch that closely as well.

Then you can see the estimated monthly contract subscription value ticking up as well, which is an indicator that you are in fact selling deeper into your install base, meaning people who bought a core lab subscription are now adding an Element COAG for a third with an increase in their minimum subscription value per month.

These metrics—and again, these are available on the presentation and they're downloadable, but I think it gives us good insight into the trends.

In terms of subscriptions that are eligible for nonrenewal, another key metric. Our job is—for shareholders, so I'll look at it from that perspective—is to deliver consistent growth and earnings without having it unexpectedly stop. So on any subscription model it's important to understand how many of those subscriptions are eligible to stop. Our metrics are, I think, quite good. In 2018, 11% of all our subscriptions are eligible to leave, and what that indicates is that many of those customers between their 2013, '14 and '15 initiation have already upgraded their program and extended their program, generally, for 72 months, leaving only 11% that haven't done that. The ones that don't upgrade their program, we believe the majority of those auto renew. They're quite happy. They don't want additional analyzers. They're not looking to leave, but we've seen very good evidence of that. You see that rises 14% and then 19% in 2020. That's simply a step function. Our job is to go back to these folks, generally a couple of years before they're even eligible to leave, offer them a new value, a new benefit to increase their analyzer placement in exchange for a longer term. It's a good trend.

The reason it's a good trend, 96.4% retention rate is—95% of the customers when we ask say they're happy, and that's a good reason to stay. They're satisfied with Heska. They're satisfied with support, so even if they've had problems or warranty 90% of the satisfied with that. Again, they're satisfied whether or

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not they're an Antech reference lab customer or an IDEXX reference lab customer. You would think an Antech reference lab customer would have a supportive base in terms of their interaction with the Antech laboratory sales rep, and an IDEXX sales rep would be the competitor voting no, but even with the competitor voting no in 38% of those cases, 95% of our customers are happy. So, we think these are very good metrics and they're encouraging.

I'm going to give you one more 'what are our customers saying' and then we're going to dive into our growth plan for the next five years.

(Video Presentation)

Again, I love our business. I love our customers. It's not a sales pitch. These are real people. They're not paid for their endorsement. They're hitting on the things that we want them to hit on because we have a team and I think it's doing a great job. I think that's what shareholders look for. We're doing work to add value, and there's no magical mystery about that. One customer at a time you've got to delight them and outwork them. We have big competitors and they do great things and that's the game. That's what's fun. That's the competition, but ultimately I think that's the metric that matters. I think it's the best jumping off point that we could hope for, going for the next five years.

What that, I'm going to move on to what our next five-year plan looks like. Like anything, I guess it gets more complicated over time. So, the first five-year plan had five points, like this one has seven, but we're going to focus on growing market share; we have to continue to grow products, which is something that we did in the first five years; grow margins; we have to grow the sales team; we have to grow utilization; we're growing geography; and we'll look for the ability to acquire or license in things that are beneficial to using our NOL tax position, just in terms of free cash flow after tax and the ability to utilize that.

So, Heska growth, where are we headed with these things that we're going to talk about today built into the model? Understanding that we're working on additional things, but the things that we're going to share with you today. Our 2022 target is $260 million in revenue. We think we can grow gross margins 49.5%, which is consistent with what we did during the first five years, and we think that trend continues. We think operating margins will similarly grow and will be in line with our competition as we scale our business, which … (audio dropout) … my own targets are in terms of Heska. Share prices are a little bit higher than the Management Team target. Maybe I'm more bullish, but I thought this would be helpful for you to understand that we're all in the same boat and we're all driving towards the same targets.

So, a couple of ways to get there. I'm going to start with just incremental. We think our imaging business is growing 10% to 12%. It was up 33% in the first quarter, so a little bit ahead of expectations. Just on a long-term basis, we think that's a good solid grower. Based on new extended maintenance agreement revenue that just started kicking in this year, the integration of that business into Heska proper is complete. Then, primarily new products, there's been the release of Slate 1 in the first quarter, but there's a whole slew of products that are designed and pending release this quarter through the fourth quarter that we think will have knock-on effect on growth for quite some time. We're expanding the sales team in Imaging, as well, by 10%, which, for those of you who are counting, is roughly three to four people, so it's not a huge ask in terms of recruitment, and we intend to launch a telemedicine service, which is the ability then to have kind of a long-term revenue stream associated with the placement of imaging analyzers. So, that's the growth plan in Imaging.

An important factor as we go through the model and our plans is that Heska is playing offense. We have what's commonly known as the attacker's advantage. Every customer that we gain is a gain. Every customer that the incumbent defends and gives up anything in defense of is a loss. I think that's just

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general law of small numbers and, again, a fairly common term is that attacker's advantage. We get to play offense. I think we're a proven share gainer. We started at 3%, we've gone to 10%, so we're starting the next five-year term at 10% and we think we can continue to gain share. Part of doing that is we'll expand the North American sales team 25% in 2018, and I'll talk about that a little bit—I'll chase that one right now.

A big piece of out expansion plan for our sales force is to increase coverage, but at the same time increase coverage while giving new product lines. There's not a sales rep in the world who likes to have a shrinking territory and fewer addresses to call on, but if you can layer in new products into the bag that they carry that they can offer, so you can improve the value of that bag by 25%, they can lose 25% of their addresses and, in most cases, because they're more efficient and they have a new thing, they can improve their efficiency and that should improve their pay. So, we're basically pairing up our density increase in sales team at the same time that were increasing product lines which they can sell. This is not a "hey, they're hiring, so we should hire" type of response, and I think that's an important distinction.

Then, we'll expand our international point-of-care laboratory market share. We're roughly zero percent today, so we're bullish on the expansion. Jason Aroesty is here today. He won't guarantee me better than zero, but I suspect he'll do better than zero, and we'll talk about that in a little bit, as well.

In terms of 2018, obviously this is forward-looking, and forward-looking means different things to different people. So, some people, forward-looking is what's going to happen in June. Our market share goal for the year is 450. We believe we've secured, either installed or committed, 296 of those for the year, so roughly 66% for 2018, leaving 154, so we believe that we're on track, and our target was 200 free-standing hospitals and roughly 250 corporate hospitals. Now, the corporate accounts are an interesting opportunity for Heska. The benefits of reset subscriptions for one hospital are substantial. When you multiply that times 150 hospitals, as a corporate group owner, they're enormous, and they're really compelling.

We've been having some success in that area. Last year, at the end of the year, we announced that we won the PetVet Care Center account. Their commitment is—I believe it's 80% of their hospitals will convert to Heska's subscription analyzers in 2018. The vast majority of those are not on Heska currently, so that's an example of a large corporate account win.

What's important to note on that is they have expansion plans. So, when we win a corporate account, the corporate account then tends to want to grow 10%, 20%, 30% a year; meaning, if they own 100 hospitals currently, they have a budget to acquire 10, 20 or 30 in a year. If their commitment is to run 80% of those on the Heska program, by definition, that business development directly affects our ability to get into those accounts. So, those are important wins and they're important just in terms of long-term growth. Should they ever merge with somebody larger, we think that's also a strategic way into other accounts that we may not own in terms of that subscription, and we think that when the smart people who own them, the acquirer will get return on investment and 20% of the profitability of the hospitals that they own, and they wonder why the corporate group that they just bought is more profitable and 20% of the revenues than their current hospitals, we think that's a good opportunity for us, maybe, to win that business, as well. So, our corporate strategy, I think is an important initiative for us and I think we're doing a good job in it.

Growing test supplies, we've stated several times that our target is 15% to 20% growth in consumables. I think Catherine made the case that that's the metric that we're most concerned about. It's the highest margin in our business and it is the reason we place assets in veterinary hospitals.

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Growing market share, we've discussed that, through new subscriptions and corporate groups, but growing utilization is also part of that, so there are a number of factors that roll up to that 15% to 20% growth. I think, when you look at it like a cake layer, it starts to make sense why we think there's good visibility in that.

The first is, as we started at the very beginning, veterinary medicine is a great place to be. if the veterinary practice is seeing 5% more pets per year and roughly 15% of pet visits result in a diagnostic, there's 75 basis points in growth, based on the growth of the customers that we already have, they're consistent with that. So, that's very helpful.

Growing price—actually, I'll back up. On the utilization, I'm a big fan of our bigger competitors, they do a great job of utilization, but Heska's subscription customers go to the same seminars and they go to the same trade shows that the customers of our bigger competitors go to, and so when anybody in the market drives utilization and tries to move that number of 15% of pet visits resulting in a diagnostic going to 16% or 17% or 18% or 20%—and I agree with our larger competitors that there is a great deal of growth to be had in that in terms of just more diagnostics—I think that 15% number can grow and fully supportive, and I think it's significant, I do think they do a good job in that.

Growing price, we have price protection, as we discussed. That is a benefit that our customers rely on. It's also something that our competition has been very reticent to follow us on. It's a hard thing to commit price increases. We've got it baked into our numbers just in terms of our subscriptions model and I think it's a very good thing that we're on that. That is a nice, smooth ramp, and what I mean by that is we don't take a price increase January 1, with a big visible "Oh my gosh, we took a price increase." The customer that signed up for a subscription in April gets their increase in April, a customer that signed up in May gets theirs in May, June gets theirs in June. So, you have a very nice, smooth lift in terms of price realization month after month after month, without having the step-function of, "Here's what your old price was, here's what your new price is," amongst your whole install base. I think that's an important factor.

A step-function we just did do, we have kept our reset pricing consistent on our tests, and in the fourth quarter, we raised our starting price by a dollar. Our pre-surgical panel went from $12.75 to $13.75, and our comprehensive panel went from $19.75 to $20.75, which is a nice price increase for us. What's important about that is we hadn't taken a price increase since the fourth quarter of 2014, while our competition had taken several price increases. So, the value that we offer day one, when we were running numbers with potential customers, had almost gotten too large, and so we were able to, underneath that umbrella, increase our price. Because it's such a nice space and we do have very good market leadership that continues to raise prices on customers, it allows us then, under that umbrella, to raise our price and still maintain the fact that we think we're the fairest price in the market.

Then, growing product, just like the first five years, product, product, product is what delights customers. We have to continue to add new instruments and we have to continue to add new tests to the instruments that are already installed.

When you roll all of these things together, market share, utilization, price and products, that's what we believe drives 15% to 20% consumables growth.

Let's talk about growing products. I'm going to divide today into two buckets, what I'll call incremental products and then what I'll call major new product announcements.

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So, for incremental products, we already talked about the Element COAG. We have announced the Element DC5x, which will begin shipping in the third quarter. Then, our Heartworm Solo Step Reformulation is now pushed out to the second quarter of 2019, and I'll talk about that.

The Element COAG, the new analyzer for us, in the first quarter of 2018, we placed roughly 150 of them, so the uptake on it has been good. The important thing when I quote these numbers is to understand that most of these conversations with new placements, if they go into existing customer accounts, result in extensions. So, when we go in and place an Element COAG into some facilities that have perhaps a chemistry and hematology and immunodiagnostics, and they place an Element COAG, they fall into extend-and-renew bucket. Where they might have 30 months left on their current contract, they'll renew for 72 months, and then we end up with that net pickup of 42 months. So, that model holds true.

The Element DC5x, it is professional grade, I guess is the best way to put it. It's the fastest. It stages five patients at a time. It is squarely targeted to the highest volume, highest utilization customers that we all covet. Most of our competition, we believe, would have to place several analyzers on the counter, which is bad workflow just in terms of just managing patient IDs, patient samples, reporting tests back and forth, entering all these different samples into different machines. The Element DC5x does the work of several machines, and we think the large specialty hospitals, in particular, of which a lot of the corporate groups own several, that we think this is a key product in terms of winning the best customers. That, and it's really cool. It's a brand new release and it is very cool. So, the team did a great job on that.

On our Heartworm product, we've been working on this for some time. We intend to address the Heartworm market, which we believe is being overserved, and what I mean by that is there's a place for value products that performs a heartworm test, which is a recommended annual test, that doesn't cost $14 and provides other things that you may not need. Part of that strategy for us is to launch a lower cost version of that, which cuts our costs by roughly 40%, and we think that gives us room then to launch OEM private label versions of that product. We think that allows us then to do cross-promotions with the Merck Tri-Heart, which is a treatment for heartworm, that you can't put pets on until you validate that they don't currently have Heartworm. So, it's a very logical test-and-treat type of cross-promotion to Heska products.

The trend reversal is not significant for us at this point. The heartworm product was a, roughly, $8 million product. It had shrunk 20%, 25% over the last couple of years. So, it's been a headwind in the numbers that we've been producing. It now sits at about $1.5 million, so it's not an at-risk item for us, but we do think that we can start focusing on that. We don't focus on it currently, based on the margins. We have other higher margin opportunities that can move the market, so we've pretty much set that product off to the side for the last several years. With the reformulation of a lower cost version, we think we can get that negative trend back to a positive trend.

The gating item on this is we have 129 outstanding samples remaining to get regulatory approval. These are Heartworm positive dogs that we have to acquire samples for from the real world, so that we can finish the regulatory testing. So, 129 is 35% of the 373 total, so we're 66% of the way there. That's the gating item.

Now, I'm going to move on to new products, which I'll call major growth initiatives, and major growth initiatives, new products, it drives market share, it drives margins, it drives sales team expansion, you need more sales people to sell major products, so we're increasing our sales force, and obviously it drives utilization, as well. So, product is key, and we've got some pretty significant product releases coming.

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The first one I'm going to cover is urine sediment and chemistry, the second is cloud data and AI expansion—well, that should be covered fourth—the Element i+ immunodiagnostics was just recently—I think it was press released this morning by our licensing partner, and then we have an automated fecal product called Element F.

Before we start, back to big markets, 94 million U.S. cats, 90 million U.S. dogs, 8 million horses, 7% to 8% diagnostics growth, it's a great market to be launching things into. This is one of my favorite slides from our competitor, IDEXX, and they do a great job identifying what the market wants, and I agree with this slide. The top three most important attributes, according to their Investor Day in 2017, 96% of respondents said accuracy, 83% said cost, I agree with that, ease of use 83%, results integration at 19%, net storage requirements and inventory management. So, we can see what drives kind of customer wants in terms of just generally what are they looking for in point-of-care diagnostics.

In terms of what does the market look like and just general healthcare—so we want to start with customer needs. If we look at what veterinarians are looking to test on a regular basis, all patients are at-risk patients. Fecal intestinal parasites, it's recommended by the CDC. Most veterinary clinics also recommend screening for fecal parasites, tapeworms, and things like that. An annual heartworm test, so that you can do an annual heartworm preventative, in certain regions of the country is recommended. For cats, you have an immunodeficiency test and a leukemia test is recommended for healthcare, and for dogs, you have a Parvo and a coronavirus, and then for annual dental care, a dental radiograph is recommended, and then for clinically indicated, digital radiography. Just the same things when you and I go to the general practitioner and we're looking for wellness, these are the things that most top-quality veterinary hospitals will recommend.

For junior wellness, wellness drives a great deal of the market, so you have different populations. Baseline blood profile, so that you can compare things at later dates to see what's changed, and then baseline digital radiography.

For senior wellness, just like in our human population, we need wellness profiles, we need things like thyroid screens, senior profiles, urinalysis, and those types of things.

So, these are the things that veterinarians just broadly are trying to test for in their patient populations, and we agree with these things, and so our job then is to address these needs. That's our job.

One of the ways for us to address those needs is our new Element i+. We've had an Element i, which is an immunodiagnostics platform, for a couple of years now, so think T4, TSH for thyroid function, cortisol, bile acid, those types of tests. Our current Element i product is a lower sensitivity product that is not capable of multiplexing, putting multiple tests on a card. So, we've been hard at work developing an Element i+. We just recently entered into an exclusive global license for veterinary and animal health, which is an expansion for us, and we've just committed to make a $3 million equity investment in our licensing partner, and we've secured rights of manufacturing for this product, which is also a new step for Heska in terms of actually have the rights to manufacture our own product, perhaps even in the Des Moines facility. We think the patent portfolio on this product is very good, we think it's getting better, and so we're very pleased with this, and we think the product itself has a huge runway.

Why do we think that? It's lower cost than our current Element i, it's smaller, it's faster, it's higher sensitivity. The product roadmap is super broad, can last us for literally decades in terms of just product roadmap. It has a very wide dynamic range and a sensitivity to it. It allows us to multiplex, so you can put six tests on a card, you can put 80 tests on a card. So, the multiplexing capability of the product is substantial, meaning you can now run panels. So, you can run a heartworm test that might also have a

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thyroid function for dogs. You can run a heartworm test that might also have a leukemia function for cats. You can build those menus based on what the veterinarians are testing for. The cost per test is roughly 50% lower than our current Element i cost. Importantly, when you get into the infectious disease testing, where we're competing with heartworm, Lyme, Ehrlichia, Anaplasma, kind of four multiplexing tests on ELISA or a lateral flow type of test, the analyzer in those areas is … (audio dropout) …

This slide shows you kind of the priorities just in terms of the roadmap that's being worked on, the very basic initial tests before cortisol, in order to get higher sensitivity, maybe multiplexing, lower cost, our current testing, and then you'll see canine TSH, canine heartworm, which we think the samples that we're acquiring for our low-cost heartworm product are also the same samples that we'll be able to use (inaudible) a dual attack on that, where we have a baseline product kind of attacking an overserved market, overpriced market, and then we have an innovative tactic where we're significantly out here on the innovation scale and kind of driving that forward from above.

Then, Allercept, you'll see we have Allercept. IgE is naturally occurring in the body and it's related to allergy. It's something that we're very, very good at, and it's an area where we think we can add a lot of value with this new product. We'll talk a little bit about allergies and then I'm going to let—I'm going to let Dr. Mike explain it to you before I talk about it.

(Video Presentation)

Besides being about the nicest guy you ever want to meet, Mike Costello, I think did a good job of laying out what the allergy product is for Heska. It's currently a roughly $7 million business. It resides in PVD, next to Tri-Heart. So, just a little bit of a reminder of where it gets reported, roughly 25% of those revenues are for testing and 75% of those revenues are for therapy. Now, immunotherapy, as Dr. Costello pointed out, is the only long-term safe solution. It's non-steroidal, it's not pharmacological, and allergy is a huge space, and I think sometimes we fall into the trap that everything in our diagnostics space is a zero-sum game, and it's not. Allergy is a perfect example of that. Zoetis is just doing a fabulous job. I think Apoquel is over $500 million in sales. So, when we talk about controlling an outbreak of allergy, Apoquel is doing a great job with that, but for a lifetime management of allergy, it's not designed to be used on a regular basis for years and years, and we think that's where immunotherapy comes in, it's all natural, it is designed to be used for a lifetime, and we've had just great success with it. So, allergy testing, we believe can be done with the new product.

If you look at how we're doing allergy currently, there are frictions in the process; meaning, the veterinarian has to stock the allergy kit and anticipate a customer coming in, they have to open the allergy kit, collect the sample, put the sample in a FedEx, FedEx it to our Des Moines—I'm sorry, to our Loveland Laboratory. The Loveland Laboratory then reports back on the allergen, the IgE, and then the veterinarian then, two days later, when they get that report, has the ability then to order immunotherapy, which is you can think about as a customized therapy based on the allergens identified, and that immunotherapy then gets manufactured and then sent to the veterinarian, who then schedules an appointment to get it to the pet owner. So, there's a lot of friction, a lot of steps in that process.

If you can bring IgE testing to a multiplexing platform and get all of those answers, and under 30 minutes, and then communicate those answers to your cloud bank instantly for a yes/no, would you like immunotherapy based on these numbers, we think we can remove a lot of the friction. We think we can substantially increase the testing revenue, but more importantly, if you increase the testing revenue, you have an opportunity to increase the long-term immunotherapy, which is basically designed to be used for the life of the pet.

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So, I think it's a great space, it's something that Heska has ridiculously good technology in, and we think allergy is definitely a growth area for the company. We think that's true whether or not people end up doing immunotherapy each and every time. My idea on this concept is, if I had an allergy break with my own pet and I came in and they could treat the breakout of allergy with Apoquel or a steroid, that's great, but my first question is what environmentally is causing this allergic reaction, and we think just even getting that testing done, regardless of how you end up treating it, is really kind of the front end of the process. So, it's a technology we're very excited about it. If we move testing for allergy into the analyzer space, on the same analyzer that's able to do things like heartworm and Lyme and Ehrlichia and Parvo and feline leukemia, and all these other types of tests in terms of broad menu, that analyzer then is now placed by a full team of 105 sales reps. Currently, allergy is promoted by a team of one, and she's great. Her name is Gwen, she does a great job, but we think Gwen needs help. So, if we can add in-clinic testing, I think that's an exponential driver to that business.

The next product I wanted to talk to you about today is urine sedimentation and chemistry. So, no surprise, we've had a couple of urine sedimentation products released in veterinary medicine recently. There are 5 million urine sedimentation exams done annually, is the estimate. Over 3,000 competitive sediment analyzers placed, so we think the market is clearly validated, but 3,000 compared to the overall size of the market leaves an awful lot of greenfield and we think we can compete effectively for that. We intend to release our urine sedimentation and chemistry product together. We think there's benefit in having both of those functions in the same product. We think customers will respond to that positively. We think the price points and the value that we can offer is consistent with what we do for other Heska subscriptions. So, it's a big business, we think it's an over $100 million opportunity, we think the Element i segment is an over $100 million opportunity, and remember one of my very early slides, you know, crawling to toddler and kindergarten, we're $130 million revenue today, so if we can enter spaces that are over $100 million and they're not fully penetrated, it's not trench warfare, it's not a zero-sum game, we think those are very good growth opportunities for a company of our size.

Moving on to the third product that I wanted to talk about today, this one is, I think, the most exciting, honestly, of what's happening maybe in veterinary medicine at this point. Fecal flotation is done daily, and it's a manual process, you take fecal material, and you're trying to identify the eggs of roundworms, hookworms, whipworms, tapeworms, trying to identify Giardia, flukeworm, so a number of parasites that you're trying to identify, and 30 million of these things, roughly, are done in-clinic, maybe another 10 million to 15 million are sent out to the reference lab. When they're done in-clinic, it's a manual process, where the fecal material is placed and it is then diluted with a sucrose solution. So, you take the fecal material, you place it and you dilute with a sucrose solution, you agitate it, you centrifuge it, and what that does is the difference in viscosity causes eggs to rise at a different rate than the fecal material, and those eggs then, ideally, get stuck to a slipcover, which then gets placed onto a slide, which then gets placed onto a microscope, and then gets manually viewed by the technician, and then probably over-read by the veterinarian. So, aside from handling fecal material and sucrose solution and spinning these things and handling it and moving it to slides, the time, the manual process is substantial, and I think solving a problem for veterinarians and for technicians, this is a big problem that we can solve.

A final point on that. Fecal flotation, every veterinary university teaches fecal flotation. It is, by far, the Gold Standard, is expected to do visual inspection. So, that is the standard, I think, medically, that we try to meet. So, much like the urine sedimentation, we believe that we can automate the entire process that I just described utilizing a custom receptacle, automate the addition of the sucrose solution, agitate that sample, remove the agitated sample, sucrose solution, put it onto the slide, automate the moving of the slide under the microscope, and then, just like a urine sedimentation product, have that microscope scan that entire slide, capture the relevant images through AI, actually identify the size, shape and characteristic of the sample views that may contain parasites or evidence of parasites, and then report

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those up to a cloud bank for full-time storage and permanent record. So, we think this product is solving a big problem. We think that market is well in excess of $300 million. We think turning that into an automated process, where veterinarians and technicians aren't spending time and handling the material, is a huge, huge benefit.

The only competition that we're aware of currently in development is IDEXX has been working on a fecal SNAP test for some time. It's roughly 10 years in development. It's awaiting release. We're unsure as to whether it does all of the worms that the veterinarians would be looking for. So, ruling out some of the parasites, but not ruling out others of the parasites, I think probably leads to a scenario where you end up doing a fecal flotation and the manual Gold Standard visualization of it in any event. So, I think that standard is very high. Again, I would remind you that I agree with that standard. The first metric that 96% of customers were looking for was accuracy, and then cost, and then integration for data and results. So, again, I think our solution ticks all those boxes and I think has an opportunity that's huge for a company of our size.

Then, with all of this data, you'll notice the last two of these products are imaging-based products, much like digital radiography and ultrasound. So, you have microscopy-based imaging of urine and fecal material, it generates a very large amount of data, that then requires the ability then to learn, so you get into the AI portion of it in terms of improving your algorithms, but also storing for the long-term on a permanent medicolegal record, storing those images, and so that's where cloud bank comes in. We currently have over a million studies on our cloud bank. It's a personal private cloud infrastructure, so it's not hosted. It's HIPAA compliant, it accepts DICOM studies, HL7 studies, so it's very diverse, and the ability then to upgrade that and move point-of-care lab testing results, urine sedimentation and fecal imaging, into that one source, and then manage that data and leverage that data, I think is a big opportunity for the Company over the next five years.

So, in review, in terms of cadence of products, we believe that we'll be on market for a year in sedimentation and chemistry in the first quarter of '19. We believe that we'll be ready with the cloud bank and AI expansion into the cloud bank just prior to that. We intend to launch the immunodiagnostics platform in Q2 of '19, relatively concurrently with the heartworm, the low-cost heartworm release that we talked about earlier, and we think the automated fecal imaging is a Q4 of '19 release. So, big products that we think will drive us forward for the next five years, in addition to the healthy growth that we're showing in our core existing business.

Also critical to our growth plans is geographic expansion. We intend to begin our preliminary international expansion in the third quarter of 2018. We did bring Jason Aroesty on about a month ago. He comes from Siemens, has a wealth of international experience, over 10 years in international point-of-care markets, and we think having that leadership in place now has got us ready to go. He is conducting a 120-day internal review of the market, the plan and the agreements that we're evaluating, following, that's always a good thing, so it'll be his plan when he's done with this review, and we'll look at the market.

So, when we're looking at markets, I thought it would be instructive to just kind of tick off some of the boxes of things that we're looking for and why we plan so carefully.

The first thing that you have to remember with the Heska subscription is remember the mutual promise, and the mutual promise is really simple: we're going to do all of these things for the veterinarian, we're going to place the technology, we're going to ship you the supplies, we're going to do the warranty, and in return for that you're going to use our products for six years for all your testing point-of-care. That mutual promise is a very high standard for Heska to meet.

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So, on an international expansion, it's really important that we have a really good, clean market, that we have certain things in place, and some of those things that we look for is obviously the market has to be receptive to a subscription model. We think those are clear. We think whether you speak German or Australian, it's clear that subscription is a good solution. We need to have a logistical efficiency plan. So, if we make a promise to customers that they can order these supplies against their monthly credit, and we have monthly credits designed in such a way as to not overstock warehouses and overstock counters, it's really important that we have a very good logistical plan in place to meet our end of the mutual promises. We have to have stable currency, stable inflation, stable political and economic environment, banking. We have to have good contract and property rights. If we're going to place our assets in clinics around the world, we have to make sure that those assets are placed in places where you have good contract rights to protect your property. Language and cultural ease of use. Then, obviously, you want a strong economy with low risk of kind of a macro shock. These are the types of things that we look for in our markets.

Our preliminary expansion will begin next quarter. Ease of entry, for our first pilot, for us is Australia and New Zealand. I think it meets all of the market tests that I just described. The estimated size of the market is about $100 million. We think we can compete effectively for that. They have a higher pet per capita than the U.S., so culturally it's a good market, as well. We have established logistics channels, so we can meet our mutual promise in terms of getting our product to our customers, and we have a small installed based of our Element DC and HT5, our chemistry and hematology, in those markets through a third-party agency over the last couple of years, so there's a known performance and some references that I think we can jump off of. We intend to begin that in the third quarter of '18.

Then, we intend to do a main international expansion in the first quarter of '19, and what that looks like is that's European focused. Some of you may recall, the earnings call for the fourth quarter, at the end of that call, we talked that we had signed a Letter of Intent for an international investment. We didn't dive into that a whole lot, but it was a nonbinding Letter of Intent to make an international investment. That is also now subject to our 120-day internal review of the plan and of the agreements. We revised that investment proposal to be in line with a joint venture structure this month and … (audio dropout) …

Be aware, too, that the landscape is constantly changing, there's mergers, there's spinoffs, and so just being aware of what's happening in the markets. While we're thoughtful about this, we're trying to lay a 20-year plan, so it's taking a little bit of time.

I'll update you on what the impact of all these investments will be for 2018. It's important we do get together every five years to level-set these things. It's hard to have a discussion on the things that we've talked about the last hour-and-a-half, so I hope it's been useful, what are the short-term impacts.

Our revenue outlook for '18, the tailwinds are simple. We have a strong baseline, we're performing well in our Core Companion Animal, I think the subscriptions are doing great. The headwinds are our OVP revenue will be $19.5 million, maybe even a hair less than that, and I think we guided to $20 million, but margin will tick up, I think we've to around 20% margin will tick up to about 21.5%, due to pulling out some of the lower margin product that we called out the first quarter.

Our Core Companion Animal infusion pumps business, to date, is about $1 million under what it was this time last year. That is a product that is not directly sold by Heska in any quantity. It's sold through all of the main distributor outlets, Henry Schein, AmerisourceBergen, MWI, so all of these distribution partners, Animal Health International, distribute that pumps product. That's largely a function of ordering patterns with distribution, so we think it's important to call that out as a headwind.

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We anticipate, especially in the second half, a higher percentage of operating lease treatment on our subscriptions growth for the year. You'll recall that our target was roughly 200 independent hospitals. Most of those tend to fall in the normal 72-month term with discrete accounting treatment per capital sales lease treatment, as Catherine explained. The corporate accounts tend to not have discrete performance per address. They tend to have global corporate obligations for term, and things like that, and so most of those tend to fall into operating lease treatment. So, in terms of upfront revenue recognition in the month that they're installed, we think we'll have a higher percentage of operating lease treatment than capital lease treatment in the second half as we install more of those corporate accounts that we signed up at the end of last year and the beginning of this year. So, be aware of that, as well.

Then, of course, preparation, everything costs something. So, 355 employees. We're biting off a lot, we've got a lot of work to do. So, just doing that work, I call that out as a revenue headwind. When you're playing the longer game for 2022, and getting products launched, sometimes you might not get that extra sale at the end of the quarter. So, again, just a potential headwind.

An updated expense outlook, you'll notice we're sharing operating margin expectations for the year, and, again, I think it's important that we level-set. These are largely based on the investments that we have talked about.

So, sales and marketing expense related to our sales team expansion of 85 to 105, product launch preparation, so you have clinical marketing, you have training, you have release marketing, and incremental expansion of the Leadership Team, so when we bring on people like Jason Aroesty and leadership to drive these things, so and marketing expense was up $2.7 million over the prior year.

Our R&D expense is up about $1.2 million over the prior year, related to the new products that we've talked about.

Our G&A expense is up $2.2 million form the prior year, and that's related to new leadership and things like subscription analytics and utilization. So, we're building out our team to increase utilization and optimization of the subscriptions that we have, now that we have critical mass in that asset. Then, expanding the Strategic Development and Legal Team. The licensing, in-licensing and product development, one of which we announced this morning, requires the team to do such things, and so that falls into the G&A expense of $2.2 million over last year.

Then, capital use expectations, this isn't a commitment, but I, again, try not to surprise people as best I can, so our capital use expectations that are under consideration. This morning, we announced a $1 million Element i+ global license. We also intend to make a $3 million preferred equity investment in that license partner. Our new product partner, we anticipate, for product that hasn't been discussed today, possibly making a $5 million equity investment. When we do, obviously, we'll tie that equity investment to some growth plans, but we're not prepared to discuss those today, but it is a meaningful number, so it is on our radar. Again, it's under consideration, but we haven't done it, so it's not a commitment. Then, a $3 million cash spend if we do an independent international launch versus a joint venture structure, which could use up to $20 million in capital. Our intention would be to use bank financing, supported just by the operations of the Company, for these expansions, but I do think it's important, those are meaningful capital expenditures for a company of our size. Our friendly JPMorgan bankers are here in full support. It's not a guarantee—I understand—but I wanted to telegraph that, just so that we can use some turn signals and have constructive conversations around these topics.

Cadence, I think is very important, as well, speaking of turn signals. We're tightening up the cadence for 2018, and I think this slide, obviously, will be available for you, so you can scribble furiously or download

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it. We do believe consumables growth will come in in the 15% to 20% range. We do believe, as we talked earlier, that we'll get our market share targets. We do think that the point-of-care imaging business will be up between 10% and 12%, like we've committed earlier, and we think OVP will be between $19 million and $19.5 million, but we think the gross margin will be up to 21.5%, primarily just related to mix, just lower cost product falling out of that revenue.

Then, the longer term view, I just thought this was instructive. Instead of going from 2018 to 2022, we thought we would give you a view of what the steps in between looks like, so that there's a touchpoint. We're not prepared, obviously, to give annual guidance based on these things, yet, but this directionally is where I and the Management Team expect us to go, with that touchpoint of 2020 in between, so we thought we would share that with you.

So, with that, that is the end of the formal presentation. We can open it up to questions, because I think we have a lunch available for you in about 15 minutes.

Male Speaker:

Good morning, Kevin. You laid out a pretty impressive plan for five products, the new products (inaudible), but your R&D spend is only up, I think you said $1 million or $1.5 million over last year. How do you get all that done on a $1.5 million increase?

Kevin Wilson:

Yes, I'll make some comments and then if Nancy Wisnewski wants to chime in, you're welcome to. So, this morning's announcement is a perfect example. I think I've stated before, you can do vertical in-house R&D or you can partner and license in technology that removes risk from the equation. The company that we just licensed in on a global exclusive basis this morning, I think has invested roughly $40 million getting the platform for the Element i to where it is today. That's R&D risk that a company of our size doesn't want to wear. Now, in return for that, you may agree with 10% royalty over a long period of time, which I think is great economics, probably, for them and for us, but if we're more assured that those products are really prepared for adding veterinary (inaudible), that becomes less about science risk, because we've been able to validate the sensitivity and ability to print these things on these tests. We're well aware now what the manufacturing costs per test card and analyzers are, so we removed a lot of risk from that, saving our shareholders the risk of $45 million.

In-house R&D is a wonderful thing, but it has to be budgeted for. I hope we're not talking about Element i 10 years from now, and I hope that we're in the fecal space quicker than 10 years, and so in-house R&D is one metric, but the result of that in-house R&D and how much of that gets commercialized is another metric. We have increased the spend a little bit. Most of our challenges then fall into how to veterinarianize the product, that fall into mechanical engineering challenges, software engineering challenges, but not raw science challenges.

Did that answer the question?

Male Speaker:

Yes, and then my second question is—there's been a lot of noise the past couple quarters on instrument revenue. It sounds like there's going to be some more noise going forward if the accounting regulations change again on instrument revenue. Why not break out consumables revenue as a line item on the income statement, because it seems like that's a much better metric on how things are going?

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Kevin Wilson:

Yes, and we've considered that. I think we've quoted the percentage of growth. I think last quarter it was 17%. I don't know that I'm opposed to that. We had to be very careful, again, sticking to segment reporting and what numbers we do want to break out.

Female Speaker:

(Inaudible).

Kevin Wilson:

Can't hear it, go ahead.

Male Speaker:

Okay, and then just the last question on heartworm testing. It seems like the USDA process is taking a little bit longer than I thought it was going to take, and I think, probably, than you thought it was going to take, too. Can you just give us a little more color why that is, and do you think that's a risk for some of these other products?

Kevin Wilson:

Heartworm is probably the highest hurdle in terms of what the USDA asks for. It's an unpleasant topic, but acquiring those samples requires us to have six dogs from a general population. Obviously, you're not going to give dogs heartworm in order to complete your study, so you're waiting for pets to come in. We have university partnerships to identify those pets that then have heartworm. Then, you have to be very specific, there are different levels of infection, and that's really only true for the heartworm product and some of these hurdles—we did this years and years ago with our initial Solo Step formulation, but we didn't retain all the samples, and so you have to generate enough new samples to test the new product. In the USDA's defense, they're not actually the holdup. It's a matter of getting the dossier fully complete, so that it can be evaluated, and then you can run your regional and in-clinic results. We think the major gating item is just that 33% of samples that we don't have. We're entering heartworm season, we think there's a cadence there that will get us there, but we don't know. So, yes, it has taken longer than I had hoped. It's not a science challenge, it's a sample challenge, and when we get the samples, I think the science will be fine.

Male Speaker:

Thank you very much, and I really appreciate all the color, particularly around the subscriptions, the number of subscriptions, but in 2020, you showed that 20% of your customers would be then eligible for renewals, so what's the strategy here around sort of attacking those customers, and is there any risk, given the fact that you have an introductory price with 4% increases, that you would then have a revenue or a price decrease in 2020?

Kevin Wilson:

It's a fair point. Keep in mind that the starting price for the presurgical and the comprehensive panel was raised by $1.00, so there's a floor under that. Yes, there's always risk of total renegotiation. In the real

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world, that actually doesn't usually happen. Our job is to run their current utilization. If they're over their minimum, we can place a new analyzer which increases their testing, increase their revenue, increase their profitability, which is very important to them, it's 20% of their revenue and their profitability. If they're already over their minimum hurdle, they're generally very receptive to that, and they're generally very receptive to the fact that if they went out on market, the other guys have increased more than 4% a year, in most cases. So, I don't think that's really the driving factor behind the conversation. There are always one-offs. Each one of these is an individual. It's a human interaction so it's not perfect, but programmatically, we haven't seen that. Would you agree with that, Steve?

Male Speaker:

On the international expansion, you targeted Australia and New Zealand specifically because of legal structure and then logistical structure that you think is in place that facilitates a subscription kind of model. When you're looking at international markets, can you talk about the decision you came to in terms of really wanting to focus on that subscription model, rather than changing your own sales model, when addressing new foreign markets?

Kevin Wilson:

Yes, I mean, there's an argument to do it the old-fashioned way and just go sell boxes, and if you think about when you sell boxes, you're transferring risk. So, you sell a box, you transfer risk. If a veterinarian just spent $25,000, you've transferred risk. So, now they want a warranty of their $25,000 investment, because you've transferred risk. That, we think long term is not a great deal for the company. We think those assets have longer than four years of useful life, five years of useful life. Some of them may get traded out before then, but some of them will run six, seven, eight, nine, ten years, because they're useful and they do a great job. Dry chemistry technology hasn't fundamentally changed in a very long time. Our competitor uses the original Kodak technology that's been licensed to them and our partner is the original Fuji technology that we do in partnership with Fuji. So, we think the performance of those products are very good. Even our competitors, I think, are a great example. We continue to run into that test, 15, 20 years old, and customers are still fine with them. So, I think long term, it's in the company's best interest to continue to own those assets, instead of setting up a dynamic where you tear it down every five years because you want to sell a new suite of products.

The other problem with that is that once you go to market that way and you get used to reporting revenues on an upfront basis, it's really hard to get off that. Converting from upfront sales models is hard for companies like Microsoft—not hard for salesforce.com, because they started that way. But we had a very, very solid transition from an upfront box model in 2013, 3% market, and we're able to convert 81% of our customers, and growing, to a subscription model. To go in reverse, just to get there two quarters earlier, I think is a bad trade. Maybe I'm just a little bit religious about it, which might be the real answer. I think we're right. I think subscriptions are better for pets, I think they're better for veterinarians, I think they're better for my shareholders, and I just think taking the time to get it right is better.

Ray Myers:

Thank you. Ray Myers with Benchmark. Kevin, what proportion of revenue growth in your forecast is from the new products versus international expansion and versus organic growth?

Kevin Wilson:

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I think the assumed international expansion is relatively light. I don't have the percentage off the top of my head, and I don't know that we're prepared to break those out today. I think if we were prepared to break those out on that level of specificity, I probably would have thrown a slide up on it, so I think right now we're going to aggregate it. Q1 is a difference. You're talking all the way out to 2022?

Ray Myers:

Even qualitatively, do you expect a lot of that growth to be from new products or mostly organic?

Kevin Wilson:

Yes, I think, historically, the majority of growth at Heska and our competitors has been driven by new products, so over half of the growth is attributable to new product lines. I think, historically, that's been true. So, when we launch an HT5, we launch an Element POC, those are growth drivers. So, yes, it wouldn't surprise me that over half of that is related to new products. I think fecal, urine, I mean, these are—relative to our size, I think these are very big opportunities. You could almost back into some of those numbers just based on kind of our baseline forecast. I think we called out 7% to 8% revenue growth just as a baseline forecast of our current business, just kind of running out our model, and then you could say that step-function is probably related to international and new products.

Ray Myers:

Great, and then an extension on thought is what proportion of customers today have all three principal analyzers from Heska and what proportion do you expect you might install these new instruments at?

Kevin Wilson:

CoreLab, we consider to be two, so chemistry and hematology, and I would say that's well over 90% at both. I may be directionally accurate and I'm going to allow these guys to throw the flag on the field, but the Satellite analyzers would be 25/30-ish percent, depending on what type of medicine they practice. Some of them can have all three of the satellite analyzers, some of them get one of the satellite analyzers, but just for context. In terms of new products, again, the competition has a vote, they always vote no, and until we roll it out and we get customers having thrilled videos, I think it would be speculation at this point. We have our expectations, which are baked into the numbers that we've shared with you, but I don't know at this point we want to break it out.

Ray Myers:

Okay, thanks.

Male Speaker:

Thanks, Kevin. Just as we think kind of the fecal space and a couple of the other products, it seems like you're going more instrument on a desk top. How do you think about competing with kind of the space there relative to something like the competitive fecal test that's more of a one-time use, you know, wrap-it asset, that doesn't take as much countertop space?

Kevin Wilson:

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Yes, I love, love, love our odds. The Gold Standard is visual inspection. Every veterinary technician has had that drilled in. When you're looking at an anagen, you're essentially looking for the exhaust caused by having a parasite in the sample. We're actually identifying the actual parasite, the number, quantity, characteristic visually. When you're looking for the exhaust, I think, inherently, that's imprecise. I go back to the original, if we see eggs, there's eggs. If you have exhaust or you don't and you have a false negative, but there is in fact parasites in that sample, I think visual inspection will ultimately prove to be the Gold Standard. So, I like our odds, but, again, the competition votes no every day and customers will have to decide, but I really think we're on the right track.

Male Speaker:

From a price perspective on that, what's the ability to compete there relative to what (inaudible)?

Kevin Wilson:

Yes, I mean, our model has us comfortably under $20 a test, but I think, based on usage, $15 to $18, somewhere in that range, provides a very, very nice return, and that return is consistent with our kind of 60% to 75% consumables model. So, I think on price, we'll be very effective.

Male Speaker:

Great, and just one more. When you talk about building out the team, I know you mentioned a two investments in G&A that were focused on utilization. With the subscription model, I guess it's a little bit of a different angle, but is that starting to be a little bit more of a focus, where you can go back into the existing base and get them higher minimums or just spend further above those minimums?

Kevin Wilson:

For sure. Again, optimizing a small base, you don't get a lot of return for the investment, but once you kind of get to that 2,000 installed base of subscriptions—you know, having people who are smart looking at the data and the usage, and they wake up every day looking at the data and the usage and how do they drive behavior, we really haven't pulled that lever, and we know it's an important lever. Again, I think our larger competitors pull that lever, and have been pulling it for years. So, I think that's something that we can layer into our game, and we are layering it into our game. We didn't spend a lot of time talking about it today, but utilization, driving utilization is a big initiative, and the larger your installed base, the bigger the dollar delta that makes. So, yes, it's important, so we are making those investments.

Male Speaker:

Hey, Kevin, great presentation. I guess the first one is on the corporate account environment. When you press released the PetVet Care Center contract, I think that was a reasonable surprise to the marketplace. Can you just maybe speak to what your funnel might look like, how many potential corporate accounts could be evaluating alternative providers, and can you just give us a sense for what percentage of your share gains will come from corporate accounts?

Kevin Wilson:

Yes, I mean, this year, we've been pretty discreet. We've called out 250, which would include the Pet/Vet Care, we think that's a directionally accurate number, and we think we've secured or gotten commitment or installed—we had that slide that we shared with you—I think we're pretty far along in that process. I'm

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not prepared to announce another big corporate win today, but I do think we're pretty far along in getting more than the PetVet Care, which are just now beginning installs. By the way, once you sign a piece of paper, there's still a hundred human beings called veterinary hospital managers and they've got 300 human beings called veterinary technicians and 400 human beings called veterinarians, and they all have to get moving in one direction in order to make these shifts. So, the delay usually is just in navigating that human factor and getting the installs. Securing the contract is super important. Obviously, we have no right to go get those installs. They have a commitment to do those things, but you don't generally want to force people to do things they want to do anyway, so we spend a lot of time collaborating with them, and if the intake is a month or two slow, we're okay with that.

Male Speaker:

Cool, and can you share, maybe, any internal metrics you have in terms of sales force productivity per rep? One of the reasons I ask is because IDEXX has over 430 direct reps in North America. You're clearly increasing to over 100, which is a nice ramp. Abaxis is also scaling to 150 to 160. So, how do you think about what the right optimal level of sales and marketing support is?

Kevin Wilson:

In terms of the direct competitive effect, you don't really change the ratio; 400 compared to 85 is fundamentally the same as 400 compared to 105. So, we're not changing the ratio by increasing that. We look at it more from bottom up, can we have a conversation with enough people. We have salesforce.com and they report their activity and they report their pipeline. When we kind of see the snake not able to move things through the pipeline, it's time to add. The gating item, also, is training. It's not really Management blessing, therefore go make it so type of situation. You want to find the right candidates, you want to invest in them. You're going to know if they're going to be productive in six months, but while they're productive or non-productive in six months, they're costing money and spend. So, I think we look at it probably a little bit more organically.

I understand why the analyst community looks at it in comparison, but I really don't think that's what drives our thought process. We just know that if we drop a urine sediment and chemistry into the middle of our sales force, the human factor is super simple. The easiest person to sell to is your friend, so the sales reps will take the sedimentation analyzer, they'll go to their friends, and we just promise you find folks, we'll get to 200 independent clinics, and sedimentation growth, and the only way to do those things is not to put your team on the try-harder program, but to anticipate that the value of the bag that they're carrying is growing by 25%, so you have to shrink the number of addresses they're responsible for, and increase that density.

That's what's driving our behavior. We're not fundamentally changing the ratio with our larger competitors. I think that's probably a little bit misguided. Then, you're just smaller than they are always.

Male Speaker:

Great, and my last question is—on the Q1 earnings call, you did indicate, in response to an analyst question about your intention to work with Henry Schein (inaudible). I guess my question today is really around whether or not this JV structure that you're contemplating has anything—is that JV structure with the same partner or is this a potential different partner?

Kevin Wilson:

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Oh, gosh, I never speculate or out somebody. I can't even nod to who the counterparty would be. Yes, I wouldn't want to do that. If it was Schein, I would want to do that, and if it wasn't Schein, I don't want to speculate.

Male Speaker:

Okay, thanks.

Kevin Wilson:

Yes, sorry.

Male Speaker:

I have two questions. Maybe the first is just around intellectual property around the new products, you know, exciting. I guess, the ingredients for the new products, the level of diligence, I guess, you're your team has done, you feel confident that you're not violating any blocking IP by other players?

Kevin Wilson:

We did. We've looked at it, and we do think there's freedom to operate. We have the appropriate safeguards with the counterparty that we're not on the hook for missing licenses to operate, so I think our Development Team did a good job in that area.

Male Speaker:

The second question is around instrument timelines. The earlier diagnostic timelines always get shifted out. An example, I guess, is heartworm, and that kind of thing, which is understandable, but I guess your level of comfort (inaudible) meeting the timelines that you have outlined between now and the end of '19.

Kevin Wilson:

That's a great question. It's imprecise. In our first five-year plan, we had the five things that we were going to work on, and they weren't linear, and we won some and some lost some, and there were puts and takes, and we emphasized some over a different period of time. Product development, like you say, it's imprecise, but every five year, I think I owe it to you guys to say here's what we're working on and here's where we think we can get. I think we did a good job last time of getting to where—actually, I think we exceed where we thought we could get and what we shared with you. So, I think our current product portfolio is the same. Then, some of it is also, I guess, just intent. It's not my intent to get people wild and crazy and excited on … (audio dropout) …

So, on that particular product, the ability to get it into the clinic and make it a productive asset, that allows you to grow that menu over time. So, that's kind of the focus for that, is start with the easier unregulated wins in the market. I think we called out Q2 of '19 for that product, which we think is consistent with where we want to get with the heartworm product, which will be a regulated product. So, if we beat that, we would be beating that on a limited release with unregulated product.

In the urine microscopy for sedimentation and for chemistry, we feel like there's a fair amount of risk squeezed out of that. There are two examples in the market, and one has just recently launched, we think, which has better method of operations, so that's the method that we're (inaudible), evaluating larger

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sample size of urine, low base, as opposed to centrifuging a fixed smaller sample size, getting issues with that. So, we have the opportunity then to see which of the technologies we want, and, again, being a little bit cautious. I don't want to go all-in in HDVVD (phon) only to find out that (inaudible) wins. I don't want to go all-in on Vetamac only to find out that VHS wins. If that means we're a year late and we're a medium-fast follower, but we squeeze some of the risk out, I think that's a good trade, all of which is to say I don't think the science behind urine sedimentation (inaudible), mechanical engineering challenge and a software challenge are areas that I'm fairly confident in, in terms of the imaging and software.

A very long answer, but I hope it was helpful.

Jon Aagaard:

We probably have time for just a couple more, I know we've got time here. Lunch is almost ready.

Male Speaker:

Good morning, Kevin, a thoughtful presentation, and thanks for taking the questions. First off, on the international expansion, and a lot of thought obviously has gone into that, but I was curious about the joint venture structure. Is that something you guys originally came up with or the potential major global veterinary partner, or how did that come about? And then, if you do decide to go that route, what does that $20 million go to?

Kevin Wilson:

Yes, that's a bookmark, and so, again, trying to telegraph that there could be large use of capital that we would think would have a large accelerant in terms of revenue and profitability associated with that larger use of capital. So, for us, it's just a time-to-market question. If we can get there with friends on a global basis and focus on product and customer, and have logistics and those types of things with a partner, we think creating a joint venture gets us to market very quickly, and that has, I think, great value to our shareholders. If we can't do that on an economic and long-term basis that makes sense, we won't. We won't take that shiny thing and say, hey, the urge to get there quickly will kind of override the long-term structure, we're not shifting economics unreasonably. Then, some of it's not even in negotiation. It's just detail, it's just getting it right. These things can fall apart for main things or they can fall apart for minor things. All I'm trying to do there is just call out the rough, rough size of the capital that you should expect. Because, if I'm sitting in your chair, I'm wondering is this a dilutive issue, are we going to do shares, these are the types of things that would be running through my mind, so I'm trying to put context around the conversation, and I think we've got it about right.

In terms of the genesis of it, I think our Development guys are smart and they read the same business books and they go, oh, wow, we could build it and we could buy it or we could partner it. So, for a year-and-a-half, we've evaluated all three and I think all we're indicating is we're kind of getting down to crunch time, where we think we're ready to make a decision.

Male Speaker:

Okay, that's helpful, and then real quickly for me, just on the consumables sales you'll have with these larger—or these new product introductions, does the margin on those products look pretty similar to the current consumables margin?

Kevin Wilson:

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It does, and I think it's either at the midline or a little higher than the midline, so I think it'll be helpful to gross margin tick-up that you see in the model.

Jon Aagaard:

Any final questions? Well, we appreciate everybody's time today. Kevin, I don't know if you have any closing remarks, but lunch is right behind me. Please look for folks with the (inaudible) nametag. We're all Heska, and we'd love to meet you and chat further.

Kevin Wilson:

Yes, thank you, and I meant what I said earlier; I'm always flattered and humbled. We love what we do, we try to be really good at it, and I'm always amazed you guys donate half your day to communicate with your clients or you make investments on behalf of, or even in some cases with your own money, so that's flattering and we take it very seriously. I hope today was helpful. I know we didn't share everything that you may have wanted, but I hope we got it about right and you have a pretty good idea where we're headed. So, thank you. We'd love to buy you lunch. So, with that, we'll go ahead and end the presentation. Thanks.

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