

ZTS, KIN, PAHC - BUY - Read-Throughs from Elanco's 2Q14 Earnings Results Positive for Industry

SECTOR: Specialty Pharmaceuticals

July 24, 2014

Takeaways from 2Q14 sales for Eli Lilly's (LLY, NC, \$64.25) Elanco indicate: 1) good prospects for positive margin growth in 2014 for production animal business, as we see continued signs of the industry exiting the down cycle due to both volume growth and higher prices; and 2) M&A in the animal health industry is likely to continue and should drive up valuations for animal health companies, including ZTS (BUY, \$32.84), PAHC (BUY, \$20.22), and KIN (BUY, \$15.78).

- **Elanco delivered 2Q14 revenue growth of 11% in performance terms (excluding F/X impact), driven primarily by increased volume.** Total animal health sales OUS grew 21%, driven by higher volume for production animal products. Total U.S. animal health sales increased by 3% due to U.S. volume increases for production animal products, which offset volume declines for companion animal products.
- **Production animal volume increase underscores market turnaround for livestock.** Production animal business grew 27% in the U.S. and 23% OUS. In the U.S., production sales were driven by Optaflexx and Posilac sales (feed additive and supplements for cattle). Optaflexx continues to benefit from the withdrawal of Merck's (MRK, NC, \$58.11) Zilmax from the market in August 2013. OUS production animal sales included ~\$25MM from Lohmann Animal Health, which contributed 400bps to worldwide animal health sales.
- **U.S. flea and tick market impacted by negative weather conditions and increasing competition (generics and store brand products).** Companion animal sales decreased 32% in the U.S. but increased 13% OUS. Companion animal U.S. sales were negatively impacted by the adverse winter, which has delayed the flea & tick season as well as competitive entrants in the same category as generics and store brand products continue to enter the market. PRGO (BUY, \$157.28) also noted a slow start to the flea & tick season in recent meetings (7/18) hosted with them.
- **Novartis Animal Health and Lohmann acquisitions enhancing Elanco's market share in animal health industry.** Elanco completed the acquisition of Lohmann Animal Health on April 30, 2014. As part of the agreement, Elanco sold Lohmann's feed additives business, as it was non-strategic to Elanco. The company intends to complete the acquisition of Novartis Animal Health by the end of 1Q15, which would make Elanco the second largest global animal health company. Please refer to our previous notes on these acquisitions ([Elanco Acquisition of Lohmann Animal Health Underscores Our BUY Ratings on KIN and ZTS; ZTS - BUY - Expect Larger Scale Animal Health M&A to Increase Post LLY & NVS Deal and Valuations to Improve for Industry](#)).

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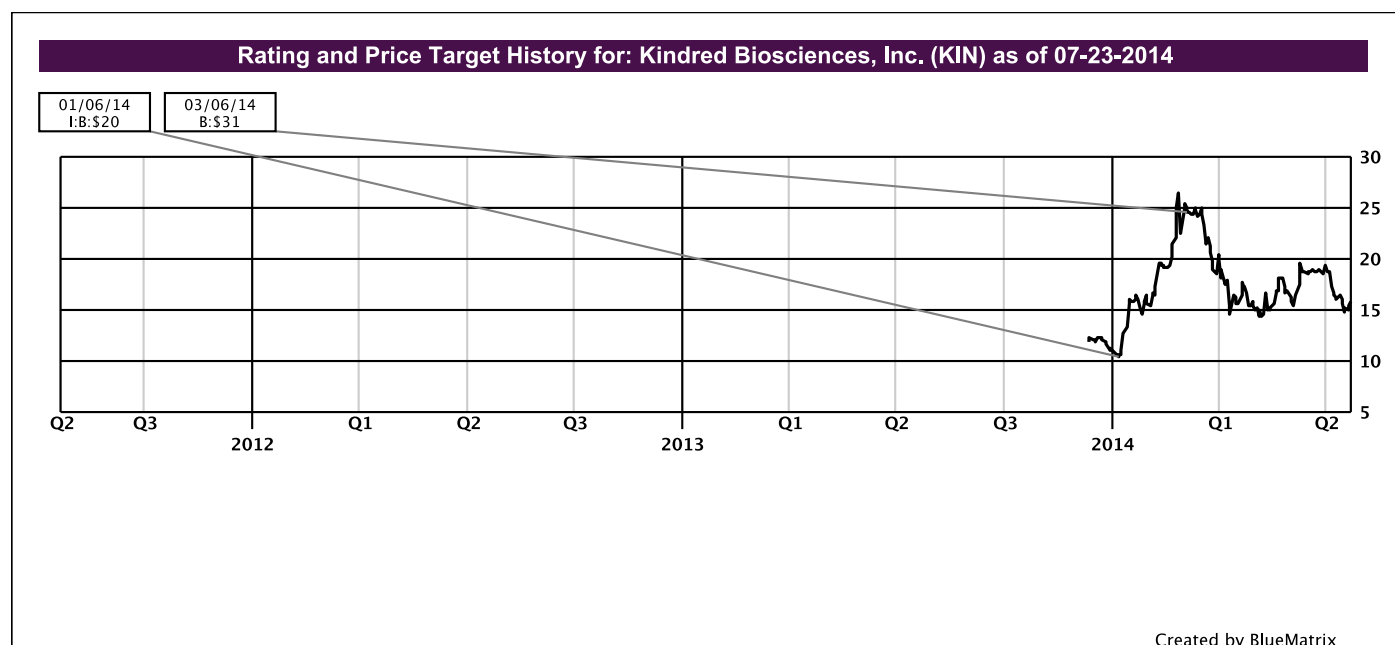
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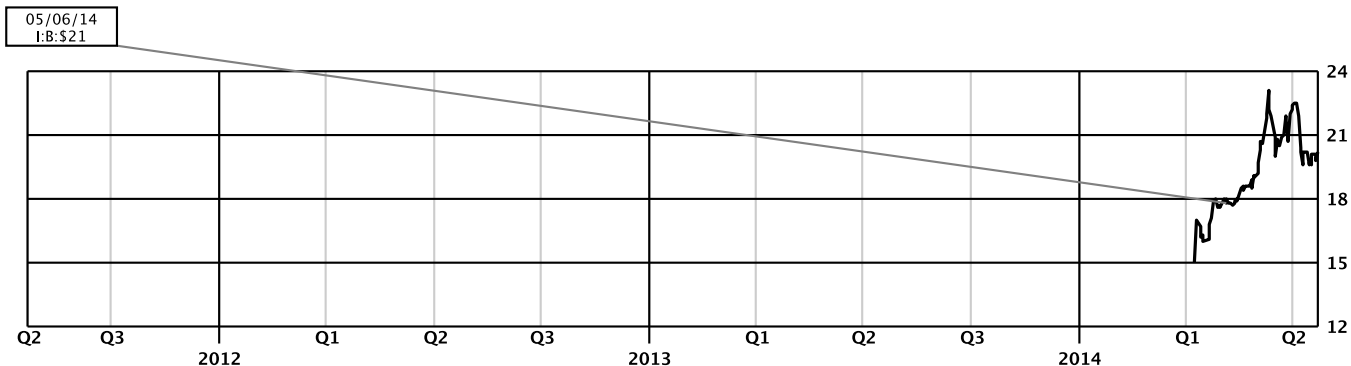
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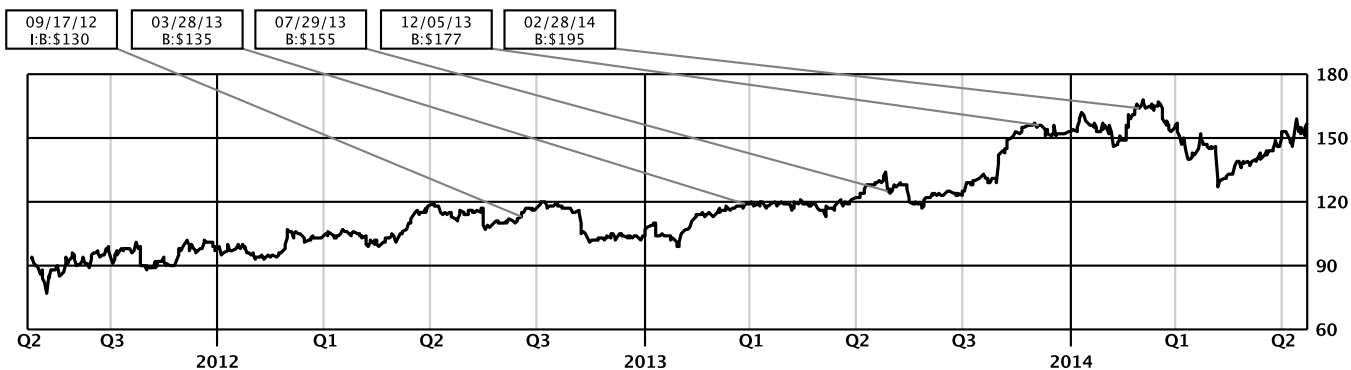


Rating and Price Target History for: Phibro Animal Health Corporation (PAHC) as of 07-23-2014



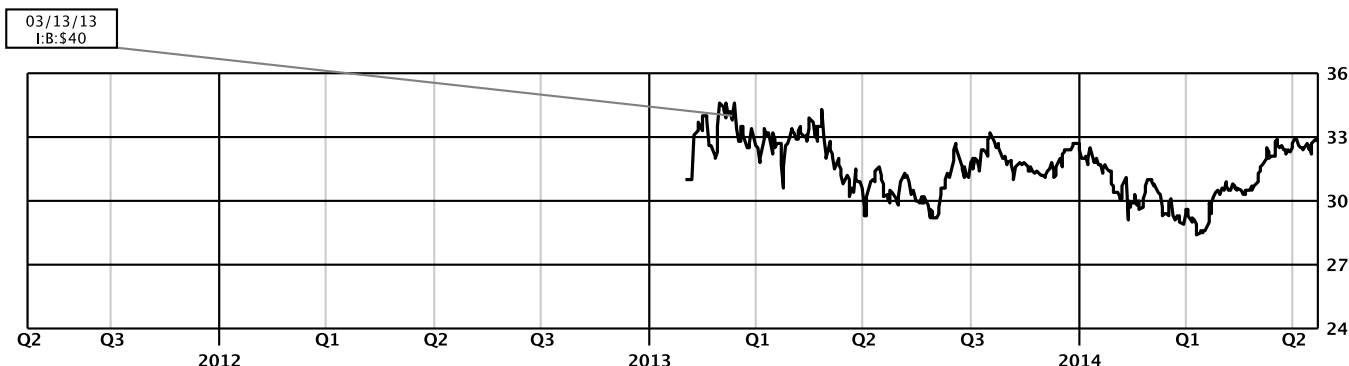
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Rating and Price Target History for: Perrigo Co. (PRGO) as of 07-23-2014



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Rating and Price Target History for: Zoetis Inc. (ZTS) as of 07-23-2014



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