

Global Equities:

how Zoetis is advancing animal health



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Global Equities

**Federated
Hermes** 
International

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 **CASE STUDY:**
Zoetis

Zoetis is a US producer of animal health medicines and vaccines

Employs approximately

10,600
people



Operates a network of **28**

manufacturing sites across 11 countries and sells its products in more than



100 countries

Within our Global Equity ESG strategy, we like stocks with robust financial statements, competitive strength and a proven ability to consistently beat revenue and earnings expectations. Ideally, these companies should also be guided by impressive management teams, mitigate environmental, social and governance (ESG) risks and appear cheap relative to peers. But very few stocks embody such an ideal investment. As such, we identify those with the most attractive combinations of fundamental characteristics and ESG characteristics in every market environment.

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Indeed, our research has found that companies that have managed their ESG risks have historically outperformed over the long-term¹. We therefore seek companies with good or improving ESG characteristics – and the latter has the potential to unlock significant value.

However, often data providers' external ratings differ and so, it is important to take an independent view of a company, focusing on the relevant material issues. To do this, we use our proprietary QESG score, which assesses a company's ESG characteristics relative to its industry peers. Meanwhile, we conduct a qualitative assessment using our unique tool, the ESG Dashboard, to integrate further ESG research into investment decisions as well as insights from our stewardship business, EOS at Federated Hermes ('EOS'). In turn, this approach helps us to identify opportunities and avoid companies with harmful or controversial behaviours.

One such example that demonstrates good ESG characteristics is current holding Zoetis, a leading global animal health company that produces vaccines and medicines for both pets and farm animals.

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Engagement timeline

Engagement objectives

We would like Zoetis to:

- A clarify its policies and procedures on the use of antibiotics in animal feed
- A establish acceptable antibiotic pollution limits from manufacturing facilities
- A improve human capital management disclosures and increase employee retention
- A increase board diversity

During a meeting with the company's investor relations team, we raise the issue of board diversity. It recognises the importance of gender diversity. We also raise our concerns about the need to increase employee engagement so as to improve retention rates.

We raise the issue of antibiotic pollution with the company's investor relations and research and development teams. We ask the company to commit to publishing an antibiotic policy.

Sept
2018

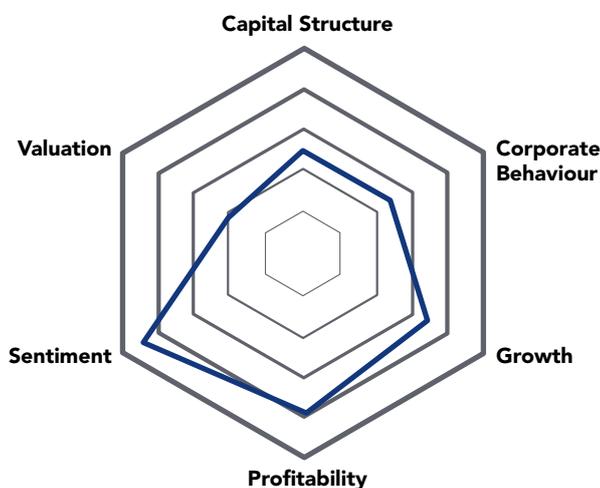
Oct
2018

¹"ESG investing: a social uprising," published by Federated Hermes Global Equities in October 2018.

Animal pharma: a growing segment

The Alpha Model – our proprietary automated analyst which assesses the attractiveness of companies in the investable universe from multiple angles over the long term – shows that Zoetis is a well-run company (see figure 1). It has demonstrated strong growth, recording revenue growth of 10% to \$6.3bn in 2019². In Q1 2020, it generated 7% operational growth in revenue and 10% operational growth in adjusted net income, owing to the strength of its diverse portfolio (notably, its companion animal products) and the global scope of its business despite the coronavirus pandemic³. However, like many other companies, Zoetis has lowered its full-year guidance citing uncertainties posed by the virus (such as expected recessionary conditions in the global economy and FX headwinds).

Figure 1. The Alpha Model's assessment of Zoetis



Source: Federated Hermes, as at May 2020.

The company looks most attractive based on profitability, with positive trends in both net and gross margins.

That said, our Global Equity ESG strategy has a long-term focus – and the Alpha Model shows that sentiment towards the company remains positive and it has a reasonable valuation relative to its peers. The company looks most attractive based on profitability metrics, with positive trends in both net and gross margins. As a result of its recent and forward-looking earnings growth, and owing to the essential role it plays in sustaining and protecting animal life, we view Zoetis as a resilient, attractive investment – despite recent downward revisions to its full-year guidance. The company expects to see a strong recovery in sales for 2021 and further growth in 2022.

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Figure 2. Zoetis' share price has more than doubled in recent years



Source: Federated Hermes, as at May 2020.

Furthermore, the company remains focused on its future growth: in April, it acquired Performance Livestock Analytics, a technology company that simplifies data for the livestock industry to accelerate progress in precision livestock farming and improve the sustainability of producers' operations. It also recently unveiled a new insurance unit in a bid to take advantage of rising pet ownership in the US.

The company confirms that it is reviewing its ESG strategy and disclosures – this includes plans to implement a global policy on antibiotics and policies on human capital management. It also confirms that it audits suppliers on antibiotic pollution and acknowledges our concerns about the need to establish an internal pollution limit. We ask for more details on the company's research on alternatives to animal testing and agree to share industry practices.

The appointment of a new female CEO increases board diversity.

Oct
2019

Jan
2020

²“Zoetis 2019 Annual Report,” published by Zoetis in February 2020.

³ “Zoetis Announces First Quarter 2020 Results,” published by Zoetis on 6 May 2020.

Zoetis acknowledges that animal-based biomedical research remains vital to the evaluation and regulatory processes of new medicines.



Farms and pharma: acting with integrity

Zoetis is committed to advancing animal health: it works to predict, prevent and treat illness in animals and address ever-present as well as unmet medical needs. In doing so, it helps to protect and enhance public health.

Guided by its core beliefs, the company seeks to act with integrity. Zoetis acknowledges that animal-based biomedical research remains vital to the evaluation and regulatory processes of new medicines⁴. However, it commits to treat animals humanly as documented in its policy on animal care and welfare. At the same time, it is committed to the development and use of scientifically validated alternative testing methods that are acceptable to regulatory authorities. It continues to engage and participate in cross-industry efforts aimed at developing and refining new in-vitro testing and predictive informatics-based systems that could reduce animal usage in the future.

The company also ensures its operations are sustainable from the research stage through to the entire lifecycle of its products. Its firm-wide environmental programme seeks to reduce the environmental impact of its operations and products on society. This includes focusing on energy and GHG reduction, natural resource conservation and production process improvements, pharmaceuticals in the environment, and products and services which would benefit both the business and its customers.



Engaging on animal health

Zoetis is less exposed to ESG risk than human-focused pharmaceutical companies. In addition, the company has no material ESG-related controversies.

As we've already mentioned, within the Global Equity ESG strategy, we use the QESG Score to assess a company's ESG characteristics. This score reflects the current behaviour of a company and, crucially, how it is improving. Those ranked higher than their peers are favoured. Zoetis scores particularly well from a governance viewpoint. And while the company does lag its peers slightly on environmental and social measures, it should be noted that the company's sole focus on veterinary medicines presents a distinct risk profile compared to its human-focused pharmaceutical peers. As such, despite appearing in line with or even lagging peers on individual metrics, overall the company tends to score very highly due to lower ESG risk exposures. It ranks in the top five industry leaders on corruption issues.

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The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

⁴For further information, see: <https://www.zoetis.com/responsibility/index.aspx>

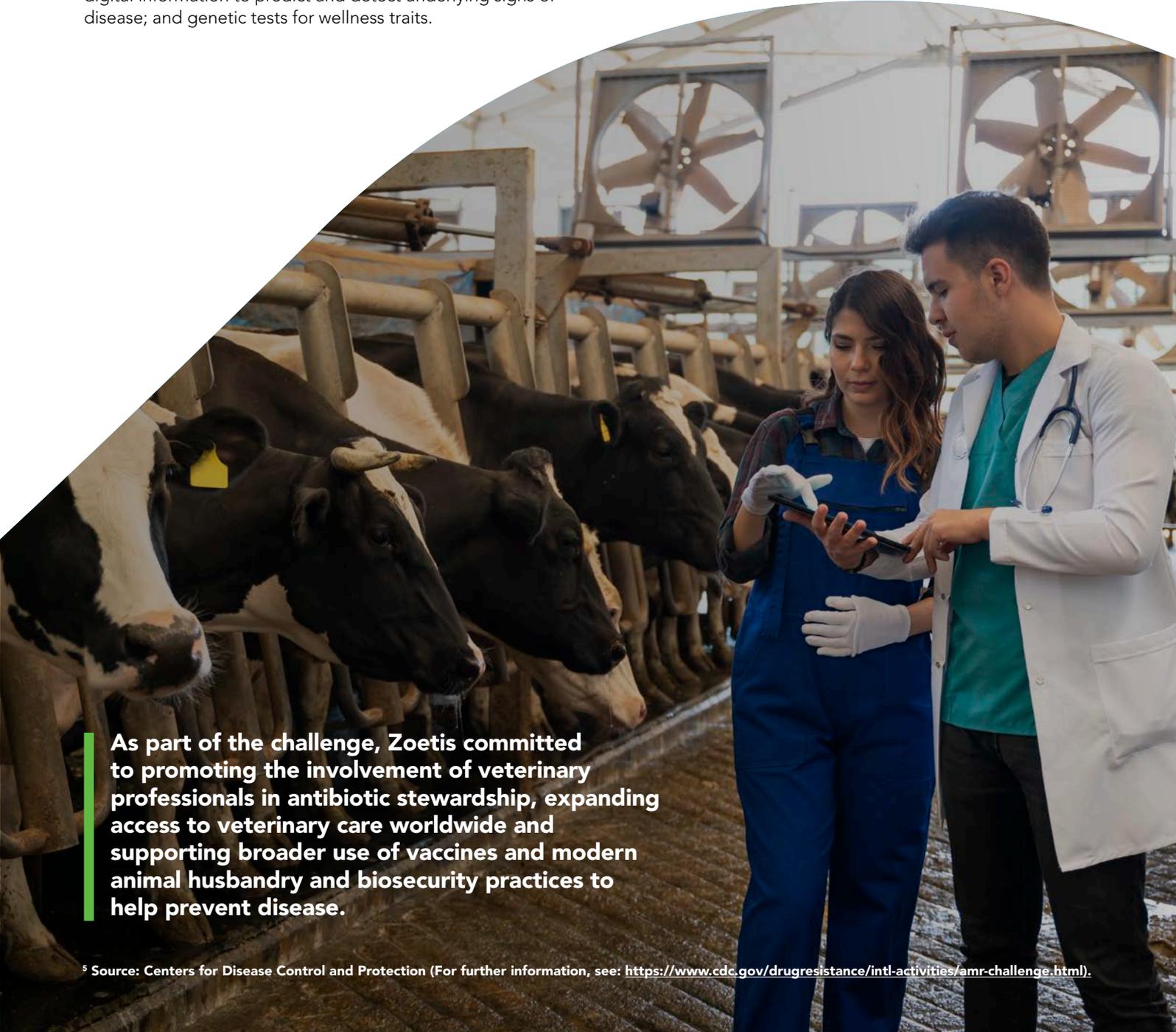
Alongside our colleagues at EOS, we engage with Zoetis. Thus far, the company has been receptive to our engagements: we have had in-person meetings and calls with members of the investor relations and innovations teams. We have been engaging on the topic of antibiotic stewardship, encouraging the company to establish a global policy and implement pollution limits in its manufacturing process. In addition, we have been engaging to encourage the company to increase gender diversity on the board and improve its disclosures around human capital management.

Last year, Zoetis joined the Antimicrobial Resistance (AMR) Challenge alongside 350 organisations across the globe to accelerate the fight against AMR⁵. As part of the challenge, Zoetis committed to promoting the involvement of veterinary professionals in antibiotic stewardship, expanding access to veterinary care worldwide and supporting broader use of vaccines and modern animal husbandry and biosecurity practices to help prevent disease. It is also working to develop veterinary-only antibiotics and antibiotic alternatives; novel vaccine technologies; diagnostic tests; sensors sending and analysing digital information to predict and detect underlying signs of disease; and genetic tests for wellness traits.

In addition, the company has expressed to us that it plans to implement a global antibiotics policy as part of an ongoing review of its ESG disclosures. And although we welcome this development, we remain disappointed that it was unable to commit to stop the sale of antibiotics for growth promotion purposes or reduce the proportion of medically important antibiotics in its portfolio.

We will continue to engage with the company and monitor its progress on these issues – and in doing so, we believe this will further strengthen Zoetis' position on ESG issues, particularly in relation to its policy on antibiotics.

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⁵ Source: Centers for Disease Control and Protection (For further information, see: <https://www.cdc.gov/drugresistance/intl-activities/amr-challenge.html>).

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- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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