

Zoetis Inc. (ZTS)

Overweight

Q1 Expectations Seem Reasonable; Pullback Creates Attractive Entry Point

CONCLUSION

We believe the recent pullback in shares of ZTS has created an attractive entry point. We believe the stock has been weak for a few reasons: 1) concerns regarding the production animal business in some emerging markets, e.g. bird flu in China, 2) the overhang from the drought in the U.S. and smaller herd sizes this year, and 3) the longer winter in the upper Midwest. We expect slower growth during 1H13 due to some of these headwinds, however Street revenue estimates of ~3% growth for Q1 seem reasonable and achievable, in our view. Treatment for some of the younger calves may shift from the March quarter to June due to recent snowfall in April in the upper plains states, which is not a major issue in our opinion. With the stock trading closer to 19x our FY14E EPS, we remain buyers into earnings next Tuesday (4/30).

- **Expect in-line FY13 guidance.** We expect ZTS to report mostly in-line Q1 results and issue FY13 guidance that is in-line with Street estimates. The Street currently expects FY13 revenues and EPS of \$4,533 MM (+4.6% y/y) and \$1.38, which compares to our estimates of \$4,504 MM (+3.9% y/y) and \$1.42, respectively. We are forecasting Q1 EPS of \$0.34 on revenues of \$1,073 MM, which compares to consensus EPS of \$0.33 and revenues of \$1,079 MM. Our Q1 revenue estimate is primarily driven by 5% growth in APAC revenues to \$182.7 MM and 4% growth in U.S. revenues to \$442 MM, while we expect EuAfME and CLAR revenues to remain relatively flat y/y. While there is some concern about smaller herd sizes in the U.S. due to last year's drought, ZTS' presence in the Latin American countries like Brazil is fairly strong and this could help mitigate some of the headwinds the company faces domestically.
- **China bird flu unlikely to have a significant impact.** We believe recent media stories surrounding a bird flu outbreak in China has raised concern among investors as farmers in China have been killing their flocks in order to prevent further outbreak. While reduced flock sizes could create a headwind for medication and vaccine sales, we are not overly concerned since ZTS has limited revenue exposure to poultry product sales in China, which we estimate at ~1%. We also believe some of the other concerns raised from competing manufacturers seem overblown, and it is difficult to draw a direct correlation from one manufacturer to another. Other key topics for the call include antibiotic use in production animals, FY13 guidance, the impact from the drought, companion animal trends, capital allocation, and margin expansion opportunities.
- **ZTS reports before the open on Tuesday, April 30th.** Conference call at 8:30 AM ET.

RISKS TO ACHIEVEMENT OF PRICE TARGET

Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

COMPANY DESCRIPTION

Zoetis is the leading global manufacturer of animal health medications and vaccines.

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2012A	1,047.0	1,094.0	1,019.0	1,176.0	4,336.0	3.7x	0.30	0.35	0.31	0.11	1.08	29.4x
2013E	1,073.2	1,132.3	1,080.1	1,218.7	4,504.3	3.5x	0.34	0.36	0.36	0.35	1.42	22.3x
2014E	1,121.4	1,193.2	1,147.2	1,300.3	4,762.1	3.3x	0.38	0.41	0.40	0.43	1.62	19.6x

PRICE: US\$31.70

TARGET: US\$40.00

(24.5x FY14E EPS)

Kevin K. Ellich

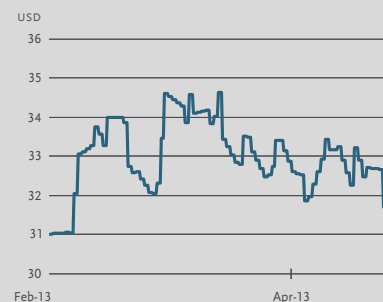
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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$40.00
FY13E Rev (mil)	—	US\$4,504.3
FY14E Rev (mil)	—	US\$4,762.1
FY13E EPS	—	US\$1.42
FY14E EPS	—	US\$1.62
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.0	
Market Cap. (mil)	US\$15,850.0	
Book Value/Share	US\$8.08	
Net Cash Per Share	US\$0.53	
Debt to Total Capital	75%	
Div (ann)	US\$0.26	
Yield	0.82%	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

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Period	FY09	FY10	FY11	1Q12	2Q12	3Q12	4Q12	FY12	1Q13E	2Q13E	3Q13E	4Q13E	FY13E	1Q14E	2Q14E	3Q14E	4Q14E	FY14E	FY15E
Ending	12/31/09	12/31/10	12/31/11	3/31/12	6/30/12	9/30/12	12/31/12	12/31/12	3/31/13	6/30/13	9/30/13	12/31/13	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	12/31/14	12/31/15
Revenues	\$2,760.0	\$3,582.0	\$4,233.0	\$1,047.0	\$1,094.0	\$1,019.0	\$1,176.0	\$4,336.0	\$1,073.2	\$1,132.3	\$1,080.1	\$1,218.7	\$4,504.3	\$1,121.4	\$1,193.2	\$1,147.2	\$1,300.3	\$4,762.1	\$5,041.8
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	2.5%	3.5%	6.0%	3.6%	3.9%	4.5%	5.4%	6.2%	6.7%	5.7%	5.9%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-8.7%	5.5%	-4.6%	12.8%		-8.0%	6.4%	-3.9%	13.3%		
Cost of sales	1,001.0	1,318.0	1,581.0	388.0	382.0	352.0	\$427.0	1,549.0	386.4	405.9	375.4	431.4	1,599.0	395.3	420.6	392.9	445.3	1,654.2	1,727.3
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	686.9	726.4	704.8	787.3	2,905.3	726.1	772.6	754.3	854.9	3,107.9	3,314.5
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	64.00%	64.15%	65.25%	64.60%	64.50%	64.75%	64.75%	65.75%	65.75%	65.26%	65.74%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	332.7	353.8	334.8	396.1	1,417.4	336.4	363.9	349.9	412.8	1,463.1	1,519.2
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	92.8	93.4	91.8	118.8	396.9	96.4	97.2	97.5	117.0	408.2	416.8
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	4.0	4.0	4.0	16.0	4.0	4.0	4.0	4.0	16.0	16.0
Restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other expenses/(income)	(1.0)	(25.0)	(28.0)	(6.0)	(7.0)	(10.0)	2.0	(21.0)	(8.0)	(8.0)	(8.0)	(8.0)	(32.0)	(9.0)	(9.0)	(9.0)	(9.0)	(36.0)	(36.0)
Total operating expenses	1,437.0	1,768.0	1,846.0	422.0	438.0	418.0	567.0	1,845.0	421.5	443.2	422.7	510.9	1,798.3	427.9	456.2	442.4	524.9	1,851.3	1,916.0
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	265.3	283.1	282.1	276.4	1,106.9	298.2	316.4	311.9	330.1	1,256.6	1,398.6
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	24.72%	25.00%	26.12%	22.68%	24.58%	26.60%	26.52%	27.19%	25.38%	26.39%	27.74%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	25.6	27.1	27.1	27.1	107.0	29.1	29.1	29.1	29.1	116.6	112.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	239.7	256.0	255.0	249.2	999.9	269.1	287.3	282.7	300.9	1,140.0	1,286.6
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	22.34%	22.61%	23.61%	20.45%	22.20%	24.00%	24.08%	24.65%	23.14%	23.94%	25.52%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	69.5	74.2	74.0	72.3	290.0	78.0	83.3	82.0	87.3	330.6	373.1
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%	29.00%
Net Income	188.0	276.0	506.0	153.0	176.0	153.0	57.0	539.0	170.2	181.7	181.1	177.0	710.0	191.1	204.0	200.7	213.7	809.4	913.5
less: net income attributable to noncont	(1.0)	1.0	3.0	1.0	0.0	(1.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income attributable to Zoetis	189.0	275.0	503.0	152.0	176.0	154.0	57.0	539.0	170.2	181.7	181.1	177.0	710.0	191.1	204.0	200.7	213.7	809.4	913.5
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	15.86%	16.05%	16.76%	14.52%	15.76%	17.04%	17.09%	17.50%	16.43%	17.00%	18.12%
Diluted EPS	\$0.38	\$0.55	\$1.01	\$0.30	\$0.35	\$0.31	\$0.11	\$1.08	\$0.34	\$0.36	\$0.36	\$0.35	\$1.42	\$0.38	\$0.41	\$0.40	\$0.43	\$1.62	\$1.83
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0
Dividend			\$0.83	\$0.104	\$0.020	\$0.002	\$0.000	\$0.13	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.26
Dividend yield									0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%
Payout			82.7%	34.2%	5.7%	0.6%	0.0%	11.7%	19.1%	17.9%	18.0%	18.4%	18.3%	17.0%	15.9%	16.2%	15.2%	16.1%	14.2%
Depreciation and amortization	103.0	122.0	137.0	32.9	37.0	37.0	30.1	137.0	34.9	36.8	35.1	39.6	146.4	37.0	39.4	37.9	42.9	157.1	166.4
Adjusted EBITDA	426.0	617.0	940.0	268.9	311.0	287.0	212.1	1,079.0	300.2	319.9	317.2	316.0	1,253.3	335.2	355.8	349.7	373.0	1,413.8	1,564.9
Adjusted EBITDA Margin	15.43%	17.23%	22.21%	25.68%	28.43%	28.16%	18.04%	24.88%	27.97%	28.25%	29.37%	25.93%	27.83%	29.90%	29.82%	30.49%	28.68%	29.69%	31.04%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.00%	35.85%	34.75%	35.40%	35.50%	35.25%	35.25%	34.25%	34.25%	34.74%	34.26%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	31.00%	31.25%	31.00%	32.50%	31.47%	30.00%	30.50%	30.50%	31.75%	30.72%	30.13%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.65%	8.25%	8.50%	9.75%	8.81%	8.60%	8.15%	8.50%	9.00%	8.57%	8.27%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	39.28%	39.15%	39.13%	41.92%	39.92%	38.15%	38.23%	38.56%	40.37%	38.88%	38.00%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.25%	3.25%	3.25%	3.25%	3.25%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%
Yr/Yr Growth:																			
Cost of Sales		31.7%	20.0%	5.4%	-10.5%	-9.7%	7.8%	-2.0%	-0.4%	6.3%	6.6%	1.0%	3.2%	2.3%	3.6%	4.7%	3.2%	3.4%	4.4%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	4.2%	2.0%	5.7%	5.1%	4.2%	5.7%	6.4%	7.0%	8.6%	7.0%	6.6%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	0.5%	0.8%	1.5%	-10.0%	-2.4%	1.1%	2.9%	4.5%	4.2%	3.2%	3.8%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-0.2%	2.7%	-2.3%	-1.8%	-0.5%	3.9%	4.1%	6.2%	-1.5%	2.9%	2.1%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	12.0%	3.3%	13.3%	51.9%	17.5%	12.4%	11.8%	10.5%	19.4%	13.5%	11.3%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	4.7%	-3.8%	5.4%	43.2%	9.8%	12.2%	12.2%	10.9%	20.7%	14.0%	12.9%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	12.0%	3.3%	17.6%	210.5%	31.7%	12.2%	12.2%	10.9%	20.7%	14.0%	12.9%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	12.0%	3.3%	17.6%	210.5%	31.7%	12.2%	12.2%	10.9%	20.7%	14.0%	12.9%

Source: Company reports and Piper Jaffray & Co. Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

April 24, 2013

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Legend:

I: Initiating Coverage
R: Resuming Coverage
T: Transferring Coverage
D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
N: Neutral
UW: Underweight
NA: Not Available
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	330	56.41	63	19.09
HOLD [N]	225	38.46	12	5.33
SELL [UW]	30	5.13	1	3.33

Note: Distribution of Ratings/IB Services shows the number of companies currently in each rating category from which Piper Jaffray and its affiliates received compensation for investment banking services within the past 12 months. FINRA rules require disclosure of which ratings most closely correspond with "buy," "hold," and "sell" recommendations. Piper Jaffray ratings are not the equivalent of buy, hold or sell, but instead represent recommended relative weightings. Nevertheless, Overweight corresponds most closely with buy, Neutral with hold and Underweight with sell. See Stock Rating definitions below.

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— Bradley D. Maiers, Research Analyst

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- **Overweight (OW):** Anticipated to outperform relative to the median of the group of stocks covered by the analyst.
- **Neutral (N):** Anticipated to perform in line relative to the median of the group of stocks covered by the analyst.
- **Underweight (UW):** Anticipated to underperform relative to the median of the group of stocks covered by the analyst.

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