

Zoetis Inc.

ZTS - BUY - Read-Throughs from Other Animal Health Companies
Support Our Positive Investment Thesis

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FLASH NOTE

SECTOR: Specialty Pharmaceuticals

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We remain positive on the long-term growth prospects for ZTS's production animal business. During LLY's Analyst Day on 10/3/13, Elanco's (LLY's animal health business) President Jeff Simmons commentary highlighted the positive fundamentals that are expected to drive long-term growth in the animal health industry. The production animal industry is driven by demand for meat, milk, and eggs. It is projected that population will grow from 7B today to 9B in 2050, with fastest growth in the middle class population expected between now and 2020. As a result, demand for meat, milk, and eggs in 2050 is expected to increase by 60%. Furthermore, with more disposable income available to the growing middle class, companion animal business is expected to grow as well.

We expect positive margin growth in the production animal business going into 2014. The cyclical nature of the production animal business is driven by commodity prices, producer margins, animal numbers, and trade. According to LLY, feed costs over the past few years have been high, resulting in depressed margins. However, the company expects margin improvement heading into 2014. Producer margin has been improving in the last few quarters, especially for swine and poultry, which are expected to remain stable heading into 2014, whereas cattle margins have been negative but are expected to improve throughout 2H13 and in 2014.

Quick take of 3Q13 animal health earnings shows 1) early signs that production animal industry is slowly exiting a down cycle with growth mainly driven in OUS/emerging markets, and (2) the companion animal industry is expected to benefit from increasing veterinary sales & visits in the U.S.

- **Elanco (LLY)** - Elanco Animal Health grew 11% this quarter (versus 6% in 2Q13), driven by volume and a benefit from the withdrawal of MRK's Zilmax in the U.S.. Approximately 11% of growth in the quarter came from the company's organic business. Production & companion animal growth was 10% and 13%, respectively. The company estimates that, of the 10% growth in the production animal business, approximately half of that was due to the withdrawal of Zilmax. Both U.S. & OUS businesses grew 11%. OUS production animal growth was 9%.
- **Virbac** - The company reported 3Q13 growth of 9.8% on a constant currency basis. Organic growth increased by 2.1% this quarter versus 1.3% in 2Q13. This rebound in organic growth is a positive indicator considering 1H13 sales were negatively impacted by unfavorable weather and economic condition. Sales were positive in all regions excluding the U.S. due to temporary destocking by distributors who postponed orders until 4Q13. Year to date, organic growth for the companion animal business was down 1% due to the slowdown of CaniLeish in the EU (which was expected) and Iverhart in the U.S. (distributor order postponement). Production animal business showed 2.9% organic growth year to date, which is higher than 1H13 and driven by emerging markets.
- **Dechra** - Majority of the company's sales are derived from companion animal and equine products. Revenues were down 1% constant currency. Strong growth in core U.S. & EU products was offset by phasing of export sales and U.S. supply issue for Animax. EU sales were down 1% on a constant currency basis due to lower export sales. Excluding the phasing of orders, sales would have grown 4% on a constant currency basis. Sales in the U.S. were down 7% due to adverse impact of Animax supply issue. Excluding Animax, growth on the other products was 9%.
- **Idexx** - The company was positive on the U.S. veterinary market based on data from the company's 700 Cornerstone customers. In 3Q13, patient visit and practice revenues increased 2.6% and 6.1% on a yearly basis. This was greater than numbers reported in 2Q13 of 1.1% patient visit and 4.7% practice revenue growth year over year.

Companies Mentioned

Eli Lilly (LLY, NC \$50.15)

Idexx (IDXX, NC \$103.23)

Dechra (DPH.L, NC, 692.00 GBP)

Virbac (VIRP-FR, NC, €148.00)

Zoetis (ZTS, BUY, \$32.51)

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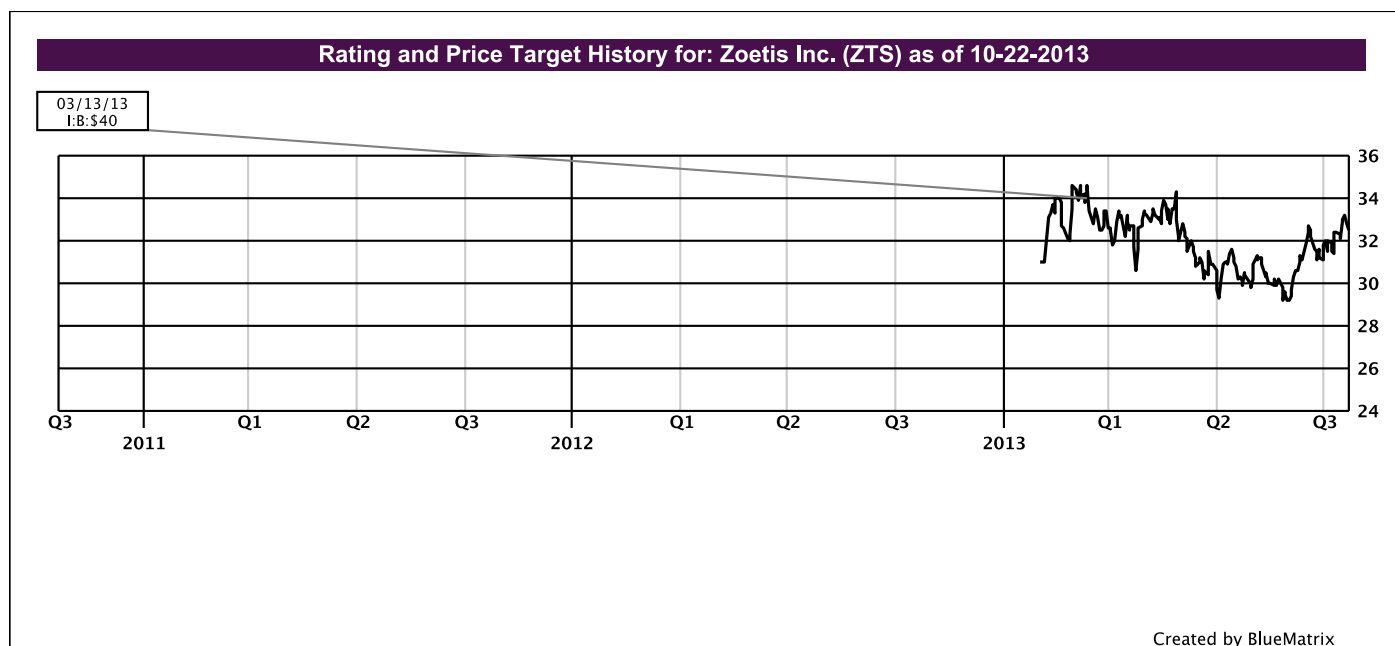
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