

Zoetis Inc.

Feedlots Improving; Costs in Check

Cattle recovery in the US: US live stock grew 6% YoY as the cattle business started to see recovery from the drought. The drought significantly impacted 2H 2012, and we will likely see good growth in Q3 and to a lesser extent into Q4. We note that the market for cattle is improving with high beef price, low grain costs and cattle inventory at all time low; this will likely incentivize farmers to maintain or increase cattle production. Management expects the market to return to pre-drought activity in the next 12 months. It normally takes 2-3 years to build the cattle herds; therefore the trends may positively impact ZTS in the near-to-mid term if realized.

Stand-up first, operating costs in check: Management provided more color on cost control and margin opportunities after spin-off from PFE. For gross margin, Q2 was negatively impacted by increased sales for 3rd party manufacturing related to prior divestures, and the company expects GM improvement in 2014. ZTS has already reduced the potential impact of 30M beyond 2015 due to increase in manufacturing costs as the two-year at-cost manufacturing supply agreement with PFE expires. For SG&A, reduction in compensation and lower spending on ad due to a cool season contributed to margin. Stand-up costs will likely be substantial in the next two years, especially for manufacturing and SG&A. Interest costs increased to \$32M compared to \$8M a year ago, offsetting much gain from operating leverage. Tax rates compared to historical level will be significantly lower.

Guidance reaffirmed, margin story unchanged: Management reiterated the previous guidance of revenue \$4.425-4.525M and non-GAAP EPS \$1.36-1.42 for FY13. We believe the ZTS story will continue to center around mid-single-digit revenue growth and margin expansions driving low double digit operating income growth. Capital allocation will not be a near term driver as stand-up costs and deleveraging will be ZTS' priority. We believe ZTS is fairly valued at 22.5x our 2013E EPS and our price target remains unchanged at \$35.00 based on 19x 2015E EPS of \$1.81.

ZTS: Quarterly and Annual EPS (USD)

	2012		2013		2014		Change y/y		
FY Dec	Actual	Old	New	Cons	Old	New	Cons	2013	2014
Q1	0.30A	0.36A	0.36A	0.36A	0.37E	0.38E	0.38E	20%	6%
Q2	0.35A	0.35E	0.36A	0.36E	0.41E	0.41E	0.40E	3%	14%
Q3	0.31A	0.33E	0.33E	0.34E	0.40E	0.40E	0.39E	6%	21%
Q4	0.11A	0.35E	0.34E	0.34E	0.43E	0.43E	0.40E	209%	26%
Year	1.08A	1.39E	1.39E	1.40E	1.61E	1.62E	1.61E	29%	17%
P/E	28.9		22.5			19.3			

Source: Barclays Research.

Consensus numbers are from Thomson Reuters

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PLEASE SEE ANALYST(S) CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 3.

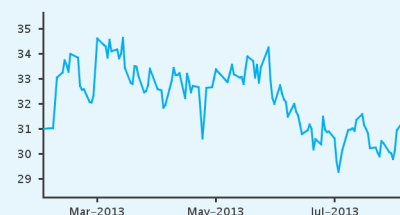
Stock Rating	EQUAL WEIGHT
	Unchanged
Industry View	POSITIVE
	Unchanged
Price Target	USD 35.00
	Unchanged

Price (05-Aug-2013)	USD 31.25
Potential Upside/Downside	+12%
Tickers	ZTS

Market Cap (USD mn)	28156
Shares Outstanding (mn)	500.00
Free Float (%)	99.93
52 Wk Avg Daily Volume (mn)	5.6
Dividend Yield (%)	0.4
Return on Equity TTM (%)	20.03
Current BVPS (USD)	1.42

Source: FactSet Fundamentals

Price Performance	Exchange-NYSE
52 Week range	USD 35.42-28.97



[Link to Barclays Live for interactive charting](#)

U.S. Major Pharmaceuticals

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U.S. Major Pharmaceuticals

Industry View: POSITIVE

Zoetis Inc. (ZTS)

Stock Rating: EQUAL WEIGHT

Income statement (\$mn)	2012A	2013E	2014E	2015E	CAGR
Revenue	4,336	4,488	4,708	4,943	4.5%
EBITDA (adj)	1,079	1,244	1,410	1,505	11.7%
EBIT (adj)	942	1,097	1,264	1,394	14.0%
Pre-tax income (adj)	911	984	1,153	1,288	12.2%
Net income (adj)	539	692	811	911	19.1%
EPS (adj) (\$)	1.08	1.39	1.62	1.83	19.2%
Diluted shares (mn)	500.0	500.2	500.2	500.2	0.0%
DPS (\$)	N/A	0.26	0.31	0.37	N/A

Margin and return data	Average				
EBITDA (adj) margin (%)	24.9	27.7	30.0	30.5	28.3
EBIT (adj) margin (%)	21.7	24.4	26.8	28.2	25.3
Pre-tax (adj) margin (%)	21.0	21.9	24.5	26.1	23.4
Net (adj) margin (%)	12.4	15.4	17.2	18.4	15.9
ROIC (%)	6.2	17.3	15.5	17.8	14.2
ROA (%)	8.6	11.2	11.5	12.2	10.9
ROE (%)	13.3	26.9	44.0	42.4	31.6

Balance sheet and cash flow (\$mn)	CAGR				
Tangible fixed assets	4,409	4,548	5,190	5,641	8.6%
Intangible fixed assets	1,853	1,875	1,856	1,838	-0.3%
Cash and equivalents	317	572	1,048	1,470	66.8%
Total assets	6,262	6,423	7,046	7,479	6.1%
Short and long-term debt	582	3,650	3,650	3,650	84.4%
Other long-term liabilities	589	589	589	589	0.0%
Total liabilities	2,221	5,208	5,201	5,331	33.9%
Net debt/(funds)	265	3,078	2,602	2,180	101.9%
Shareholders' equity	4,041	1,215	1,846	2,149	-19.0%
Change in working capital	273	230	607	-109	N/A
Cash flow from operations	454	555	802	1,133	35.6%
Capital expenditure	-126	-170	-170	-124	N/A
Free cash flow	328	385	632	1,010	45.5%

Valuation and leverage metrics	Average				
P/E (adj) (x)	28.9	22.5	19.3	17.1	22.0
EV/EBITDA (adj) (x)	14.7	15.0	12.9	11.8	13.6
P/BV (x)	3.9	12.9	8.5	7.3	8.1
Dividend yield (%)	N/A	0.8	1.0	1.2	1.0
Total debt/capital (%)	12.6	75.0	66.4	62.9	54.2

Selected operating metrics

SG&A/sales (%)	33.5	31.3	30.0	29.5
R&D/sales (%)	9.2	8.7	8.5	8.3
R&D growth (%)	-2.0	-1.6	2.1	2.0
SG&A growth (%)	0.3	-3.2	0.6	3.2

Price (05-Aug-2013)	USD 31.25
Price Target	USD 35.00

Why Equal Weight? Zoetis' current stock price appears fairly valued in our view. Macro headwinds for both the livestock and companion animal sectors will likely limit upside to 2013 earnings. Long-term growth will likely depend on Zoetis' ability to leverage its vast global portfolio to outpace industry growth.

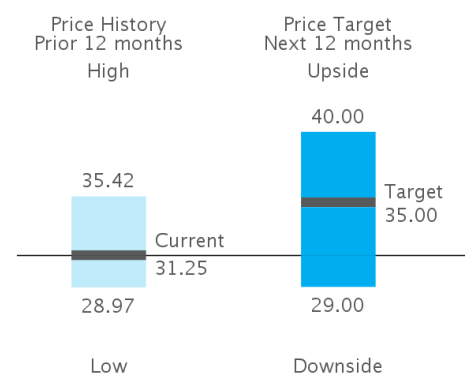
Upside case	USD 40.00
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Our upside case assumes a strong recovery of the global animal health market in 2013/14 to 5%-6% per year, and Zoetis achieving an EBIT margin expansion to 30% in the longer term. These factors should drive an upside case of \$40.00 or 22x 2015E EPS.

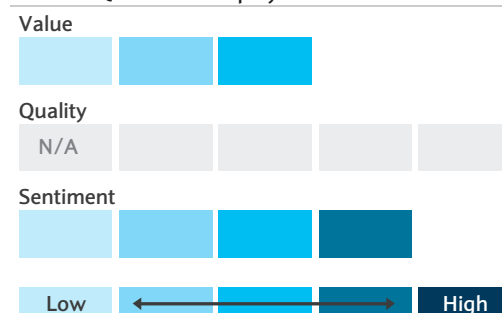
Downside case	USD 29.00
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Our downside case assumes the stagnation of the global animal health market in 2013/14. Zoetis' growth is on pace with a soft industry outlook, and EBIT margins improves to 27% in the longer term. These factors should lead to a downside of \$29.00 or 16x 2015E EPS.

Upside/Downside scenarios



POINT® Quantitative Equity Scores



Source: POINT. The scores are valid as of the date of this report and are independent of the fundamental analysts' views. To view the latest scores, click here.

Source: Company data, Barclays Research
Note: FY End Dec

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Primary Stocks (Ticker, Date, Price)

Zoetis Inc. (ZTS, 05-Aug-2013, USD 31.25), Equal Weight/Positive, A/C/D/F/J/K/L/M/O

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U.S. Major Pharmaceuticals

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Lilly, Eli (LLY)	Merck & Co. (MRK)	Pfizer Inc. (PFE)
Zoetis Inc. (ZTS)		

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IMPORTANT DISCLOSURES CONTINUED

Zoetis Inc. (ZTS)

USD 31.25 (05-Aug-2013)

Stock Rating

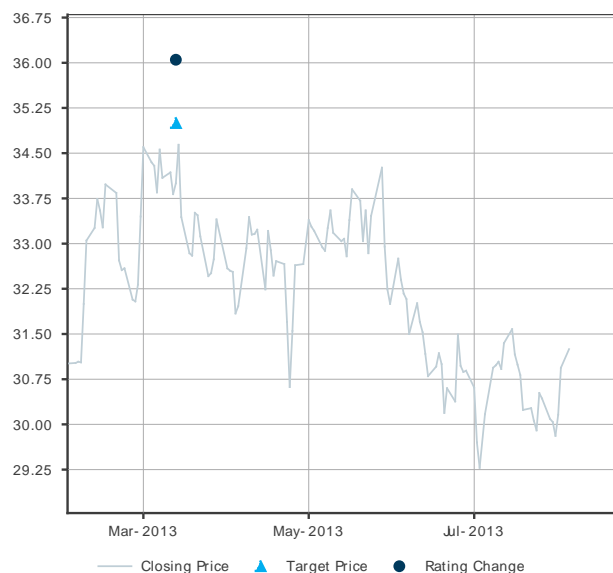
Industry View

EQUAL WEIGHT

POSITIVE

Rating and Price Target Chart - USD (as of 05-Aug-2013)

Currency=USD



Date	Closing Price	Rating	Price Target
13-Mar-2013	34.00	Equal Weight	35.00

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Valuation Methodology: Our price target of \$35 is based on a DCF analysis using a 7% discount rate and a 2.5% terminal growth rate. Our price target is 25x our FY2013E EPS of \$1.39 and 19x our FY2015E EPS of \$1.81.

Risks which May Impede the Achievement of the Barclays Research Price Target: Risk factors that can materially affect Zoetis' operations and performance include global economic conditions that may affect the consumer's demand for animal proteins and spending on companion animals, potential increase in regulatory scrutiny over the use of antimicrobials in food-producing animals, regulatory and/or funding pressures on livestock production in major markets, changes in consumer demand for animal proteins products due to perceptions of health risks, competition from generic animal health products, outbreak of infectious diseases in animals, and consolidation of customers, particularly in food-producing animal producers, and effects on Zoetis' pricing leverage. Other risks include challenges in integrating recent acquired businesses, setbacks in the R&D pipelines such as failure of clinical trials and denial of drug approvals, manufacturing and capacity shortfalls, as well as challenges to Zoetis' portfolio's patent exclusivity in major markets.

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