

Friday, April 5, 2013

Zoetis (Underperform)

(ZTS-NYSE)

Bird Flu Scare Could Lead to Increased Scrutiny of Livestock Supply Chain Practices

Flash:

Shares of Zoetis are weak today in part related to the 14 human cases of the H7N9 virus, an unusual strain of bird flu that has so far killed six people in China, which has in turn led the Chinese authorities to kill more than 20,000 birds from a live-poultry trading zone. Shanghai will temporarily close all its live poultry markets starting Saturday.

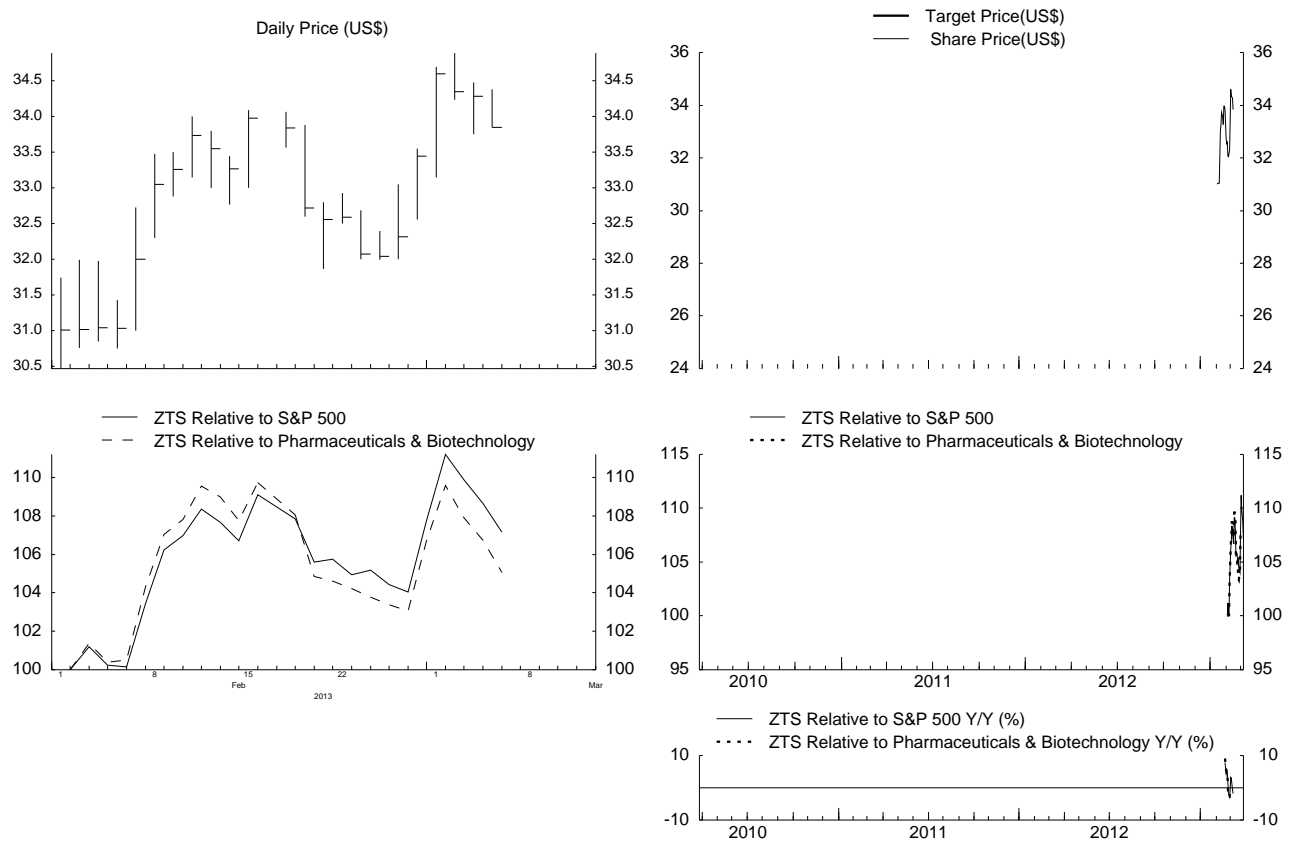
Our View:

- * Incrementally negative for Zoetis, as it leads to lower use of its livestock products. The Asia Pacific (APAC) segment, which includes China, India, Australia, Japan, New Zealand, and South Korea accounts for roughly 15%-16% of Zoetis' revenues (both livestock and companion animal). The segment is a key growth driver, and we forecast strong high single-digit growth driven by both livestock and companion animal products, particularly in China. Globally, products for swine and poultry are the key growth driver for Zoetis' livestock business (66% of revenues). Although the precise magnitude of the impact from the situation in China is difficult to quantify, the implications are obviously negative, at least in the near term.
- * More broadly, we believe that this news, combined with recent increased regulation of livestock supply chain practices in China related to poultry farmers who were ignoring laws and regulations by using excessive levels of antibiotics in chicken, bodes poorly for growth of Zoetis' livestock business in the country. Although the bird flu virus is not related to excessive antibiotic use in poultry, our concern is that this incident could lead to increased scrutiny of global livestock supply chain practices, which could result in increased restrictions against the use of antibiotics in livestock feed, escalating what we've already seen in China, US, and Western Europe.
- * Antibacterials for livestock account for roughly 27% of Zoetis' revenues. In the US, according to a relatively old study by the Union of Concerned Scientists in 2001, roughly 70%-80% of antibiotics use in livestock is for non-therapeutic use (i.e., feed). That ratio may have since declined, given increased awareness on the issue and some actions by the FDA. However, we suspect that at least half of antibacterial use for livestock in global markets remains non-therapeutic; thus, increasing the risk of resistant bacteria. Therefore, we estimate that at least 13% (~50% of 27%) of Zoetis' revenues is at elevated risk.

Company:	Zoetis (ZTS)
Price/Rating/Target:	\$31.84/Underperform/\$30.00
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This report was prepared by an analyst(s) employed by BMO Nesbitt Burns Inc. For disclosure statements, including the Analyst's Certification, please refer to pages 2 to 5.

ZOETIS INC (ZTS)



ZTS - Rating as of 28-Jan-13 = NR

Last Daily Data Point: March 6, 2013

Important Disclosures

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Company Specific Disclosure

Methodology and Risks to Our Price Target

Methodology: DCF and P/E Multiple

Risks: Demand for animal health products could fluctuate and there are relatively low barriers to entry for competitors.

Distribution of Ratings (December 31, 2012)

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
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Hold	Market Perform	60.7%	9.6%	47.1%	57.3%	48.4%	40.6%
Sell	Underperform	2.4%	0.0%	0.0%	4.2%	1.0%	5.4%

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(S) = speculative investment;

NR = No rating at this time;

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