

Zoetis

Updating Model Post 1Q Results

We are updating our Zoetis model following the company's 1Q results and 2013 guidance. Overall, the company's initial quarterly earnings came in ahead of expectations based on a combination of strong top-line results as well as lower than forecast opex. The company also provided guidance that brackets the Street and should alleviate investor concerns of a softening animal health market following mixed quarterly results from competitors over the past few weeks. We are making modest adjustments to our estimates and maintain our OW rating.

- **Solid 1Q results highlight benefits of diversified model.** In a quarter that proved challenging for other animal health players (Virbac, Elanco), Zoetis posted solid 1Q results with 4% top-line growth. We continue to see Zoetis as a far more diversified company than many of its competitors as highlighted with this quarter's results. In the US, for example, growth in companion and swine/poultry helped offset drought-related weakness in cattle.
- **Some modest headwinds in 2Q but full year outlook appears solid.** On the call, management highlighted several pushes and pulls likely to impact results over the remainder of the year (delayed paraciticide season in Europe in 2Q, lower corn prices in US, Novartis' Sentinel returning to market in the US, recovery in APAC growth in 2H). On balance, we are looking at 2Q as ZTS's lowest top-line growth rate for the year (estimating + 2%). That said, we remain very comfortable with our full year forecasts which include a top-line growth recovery in the second half.
- **Cost trends encouraging.** Zoetis' SG&A and R&D both declined 3% in the first quarter and 2013 guidance points to another year of flat/down opex. While we forecast SG&A/R&D growing in the low-single digits in 2014+, we are encouraged by this expense trend, which in our view highlights the potential operating leverage of the company.
- **Updates to estimates.** We have updated our model and our 2013 EPS forecast remains unchanged at \$1.40 while our top-line forecast remains near the high end of the company's \$4,425-\$4,525mm range. Please see page 2 for a summary of estimate changes.

Zoetis (ZTS;ZTS US)

FYE Dec	2012A	2013E (Prev)	2013E (Curr)	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
EPS Adjusted (\$)							
Q1 (Mar)	-	0.34	0.36A	-	-	-	-
Q2 (Jun)	-	0.35	0.34	-	-	-	-
Q3 (Sep)	-	0.37	0.37	-	-	-	-
Q4 (Dec)	-	0.34	0.34	-	-	-	-
FY	-	1.40	1.40	1.60	1.61	1.79	1.82
Bloomberg EPS FY (\$)	1.23	-	1.38	-	1.61	-	1.78

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 6 for analyst certification and important disclosures.

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Overweight

ZTS, ZTS US

Price: \$32.66

Price Target: \$39.00

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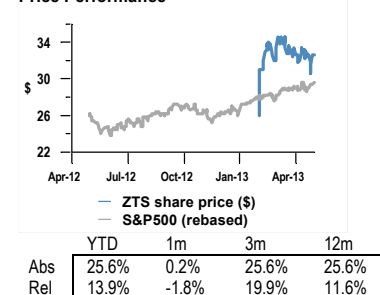
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Price Performance



Company Data

Price (\$)	32.66
Date Of Price	29 Apr 13
52-week Range (\$)	35.42 - 26.00
Mkt Cap (\$ mn)	16,333.63
Fiscal Year End	Dec
Shares O/S (mn)	500
Price Target (\$)	39.00
Price Target End Date	31 Dec 13

1Q/13 Results

Table 1: 1Q/13 Results Vs. Estimates

\$ in millions

Zoetis	JPM 1Q13E	Reported 1Q13A	Variance
Total Revenue	\$1,077	\$1,090	\$13
US	\$438	\$454	\$16
EuAfME	\$281	\$290	\$10
CLAR	\$175	\$171	-\$4
APAC	\$184	\$175	-\$9
Cost of Revenues	\$388	\$398	\$10
Gross Profit	\$690	\$692	\$2
Gross Margin	64.0%	63.5%	-0.51%
SG&A	\$331	\$322	-\$9
R&D	\$95	\$90	-\$5
Operating Income	\$268	\$276	\$8
Operating Margin	24.9%	25.3%	0.43%
Other Income	-\$25	-\$24	\$1
Tax Rate	29.0%	29.0%	-0.03%
Net Income	\$172	\$179	\$7
EPS	\$0.34	\$0.36	\$0.02
Shares	505	500	-4.9

Source: Company reports and J.P. Morgan estimates.

Updates To Estimates

Table 2: Changes to EPS and Sales Forecasts

ZTS	EPS			Year	Sales		
	Revised	Previous	Difference		Revised	Previous	Difference
2013E	\$1.40	\$1.40	(\$0.00)	2013E	\$4,510	\$4,512	(\$2)
2014E	\$1.61	\$1.60	\$0.01	2014E	\$4,747	\$4,751	(\$3)
2015E	\$1.82	\$1.79	\$0.04	2015E	\$5,019	\$5,023	(\$4)
2016E	\$2.04	\$2.00	\$0.04	2016E	\$5,321	\$5,326	(\$6)
2017E	\$2.27	\$2.23	\$0.04	2017E	\$5,660	\$5,667	(\$7)
2018E	\$2.53	\$2.48	\$0.04	2018E	\$6,001	\$6,010	(\$9)
2019E	\$2.81	\$2.76	\$0.05	2019E	\$6,331	\$6,342	(\$11)
2020E	\$3.13	\$3.08	\$0.05	2020E	\$6,682	\$6,695	(\$13)

Source: J.P. Morgan estimates.

Zoetis Investment Thesis

Maintain Overweight rating. Zoetis, a spin-out of Pfizer's animal health division, holds a clear leadership position within its industry and operates a business model that we believe is capable of generating sustainable mid-single digit top-line growth and low to mid-teens EPS growth. Further, we see Zoetis as a fairly unique asset within the healthcare space with a highly diversified portfolio, a significant emerging markets presence, and lack of third-party payer or generic exposure.

Zoetis Valuation

Zoetis trades at 23.5x our 2013 EPS estimate of \$1.40. This represents a 3% premium to its healthy-growth comps (AGN, PRGO, MJN, MON). Recall that these names trade at a substantial 60% premium to the S&P 500 on 2013E P/E.

Maintain Dec-13 price target of \$39. Our \$39 price target for Zoetis is based on our DCF with the company's mid-single digit top-line growth and substantial margin expansion over the next 5-7 years representing key drivers of our valuation. We assume that Zoetis is able to generate at least industry average top-line growth over the next several years based on the company's global scale as well as its industry leading R&D investment. We are anticipating relatively modest expense growth over this same time horizon as we see limited need for substantial expansion of either Zoetis' sales efforts or overall R&D expense levels. This combination should translate to meaningful operating margin expansion through 2017. Beyond this time horizon, we assume a gradual slowing of both top-line growth and flattening operating margins as Zoetis' business matures.

We would also note that Zoetis is one of only three companies in our coverage universe (AGN and PRGO being the other two) where we assume a modestly positive terminal growth rate (2.5% for Zoetis). This is due to the macro drivers supporting volume growth for the company's products as well as the lack of true generic competition in the animal health space. Beyond the 2.5% terminal growth rate, other key assumptions in our DCF include a 9% WACC (consistent with the rest of our coverage universe).

Risks to Zoetis Rating and Price Target

Risks to our Overweight rating on Zoetis include increasing regulation on the use of antibiotics in healthy farm animals, greater-than-expected impact from the US drought, and broader economic volatility which would impact demand for Zoetis' products.

Figure 1: Zoetis P&L

\$ in millions

millions USD	Mar 2013	Jun 2013	Sep 2013	Dec 2013	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E	FY 2018E	FY 2019E	FY 2020E
Fiscal year ends December 31	1QA	2QE	3QE	4QE								
Income Statement												
Revenue												
Total Revenue	1,090	1,112	1,079	1,230	4,510	4,747	5,019	5,321	5,660	6,001	6,331	6,682
Cost of Revenue	398	400	372	437	1,607	1,662	1,732	1,825	1,924	2,010	2,089	2,172
Gross Profit	692	711	706	793	2,903	3,086	3,288	3,496	3,736	3,990	4,242	4,510
Operating Expenses												
SG&A	322	350	329	409	1,410	1,438.3	1,474.2	1,518.5	1,579.2	1,634.5	1,683.5	1,729.8
R&D	90	94	92	117	393	402.8	412.9	425.3	442.3	455.6	469.2	481.0
Amortization of intangible assets	4	4	4	4	15	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Total Operating Expenses	416	448	424	529	1,818	1,856	1,902	1,958	2,036	2,105	2,167	2,225
Income (Loss) from Operations	276	263	282	264	1,086	1,230	1,386	1,537	1,700	1,886	2,075	2,285
Other (Income)/Expense	2	(8)	(8)	(8)	(22)	(30)	(30)	(30)	(30)	(30)	(30)	(30)
Net Interest Expense	22	30	30	30	113	115	103	84	65	54	43	32
Total Interest and Other (Income)	24	22	22	22	91	85	73	54	35	24	13	2
Income (Loss) Before Income Taxes	252	241	260	242	995	1,146	1,313	1,483	1,665	1,862	2,062	2,284
Taxes	73	71	77	71	292	332	381	430	483	540	598	662
non-controlling interest	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	179	170	183	170	702	813	932	1,053	1,182	1,322	1,464	1,621
Adjusted EPS (diluted)	\$ 0.36	\$ 0.34	\$ 0.37	\$ 0.34	\$1.40	\$1.61	\$1.82	\$2.04	\$2.27	\$2.53	\$2.81	\$3.13
Share Count (diluted)	500	501	501	501	501	506	511	516	521	523	522	518

Margins												
Gross margin	63.5%	64.0%	65.5%	64.5%	64.4%	65.0%	65.5%	65.7%	66.0%	66.5%	67.0%	67.5%
SG&A	29.5%	31.5%	30.5%	33.3%	31.3%	30.3%	29.4%	28.5%	27.9%	27.2%	26.6%	25.9%
R&D	8.3%	8.5%	8.5%	9.5%	8.7%	8.5%	8.2%	8.0%	7.8%	7.6%	7.4%	7.2%
Operating margin	25.3%	23.7%	26.2%	21.5%	24.1%	25.9%	27.6%	28.9%	30.0%	31.4%	32.8%	34.2%
Pretax margin	23.1%	21.7%	24.1%	19.6%	22.1%	24.1%	26.2%	27.9%	29.4%	31.0%	32.6%	34.2%
Tax rate	29.0%	29.5%	29.5%	29.5%	29.4%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%
Net margin	16.4%				15.6%	17.1%	18.6%	19.8%	20.9%	22.0%	23.1%	24.3%

Growth Rates												
Revenue	4.1%	1.6%	5.8%	4.6%	4.0%	5.3%	5.7%	6.0%	6.4%	6.0%	5.5%	5.5%
Gross profit	5.0%	-0.1%	5.9%	5.9%	4.2%	6.3%	6.5%	6.3%	6.9%	6.8%	6.3%	6.3%
SG&A	-2.7%	-0.2%	-0.3%	-7.1%	-2.9%	2.0%	2.5%	3.0%	4.0%	3.5%	3.0%	2.8%
R&D	-3.2%	3.8%	-2.5%	-3.4%	-1.5%	2.5%	2.5%	3.0%	4.0%	3.0%	3.0%	2.5%
Operating income	19.5%	-1.4%	18.1%	43.5%	17.9%	13.3%	12.7%	10.9%	10.5%	11.0%	10.0%	10.1%
Pretax income	10.0%	-9.4%	7.4%	38.9%	9.2%	15.2%	14.6%	13.0%	12.2%	11.9%	10.7%	10.7%
Net income	17.8%	-3.5%	19.0%	198.9%	30.3%	15.8%	14.6%	13.0%	12.2%	11.9%	10.7%	10.7%
EPS						14.7%	13.4%	11.9%	11.1%	11.4%	11.1%	11.6%

Source: Company reports and J.P. Morgan estimates.

Zoetis: Summary of Financials

Income Statement - Annual					Income Statement - Quarterly				
	FY12A	FY13E	FY14E	FY15E		1Q13A	2Q13E	3Q13E	4Q13E
Revenues	4,336	4,510	4,747	5,019	Revenues	1,090A	1,112	1,079	1,230
Cost of products sold	1,549	1,607	1,662	1,732	Cost of products sold	398A	400	372	437
Gross profit	2,787	2,903	3,086	3,288	Gross profit	692A	711	706	793
SG&A	1,452	1,410	1,438	1,474	SG&A	322A	350	329	409
R&D	399	393	403	413	R&D	90A	94	92	117
Operating Income	921	1,086	1,230	1,386	Operating income	276A	263	282	264
Note: EBITDA	-	-	-	-	Note: EBITDA	-	-	-	-
Net interest income / (expense)	31	113	115	103	Net interest income / (expense)	22A	30	30	30
Other income / (expense)	(21)	(22)	(30)	(30)	Other income / (expense)	2A	(8)	(8)	(8)
Pretax income	911	995	1,146	1,313	Pretax income	252A	241	260	242
Income taxes	372	292	332	381	Income taxes	73A	71	77	71
Net income - GAAP	539	702	813	932	Net income - GAAP	179A	170	183	170
Net income - recurring	-	-	-	-	Net income - recurring	-	-	-	-
Diluted shares outstanding	-	501	506	511	Diluted shares outstanding	500A	501	501	501
EPS - excluding non-recurring	-	1.40	1.61	1.82	EPS - excluding non-recurring	0.36A	0.34	0.37	0.34
EPS - recurring	-	-	-	-	EPS - recurring	-	-	-	-
Balance Sheet and Cash Flow Data					Ratio Analysis				
	FY12A	FY13E	FY14E	FY15E		FY12A	FY13E	FY14E	FY15E
Cash and cash equivalents	317	319	1,094	1,681	Sales growth	2.4%	4.0%	5.3%	5.7%
Accounts receivable	900	940	949	976	EBIT growth	18.4%	17.9%	13.3%	12.7%
Inventories	1,345	1,116	923	842	EPS growth	-	-	14.7%	13.4%
Other current assets	302	302	302	302					
Current assets	2,864	2,676	3,269	3,800	Gross margin	64.3%	64.4%	65.0%	65.5%
PP&E	1,241	1,261	1,276	1,276	EBIT margin	21.2%	24.1%	25.9%	27.6%
Total assets	6,262	6,094	6,702	7,233	EBITDA margin	-	-	-	-
					Tax rate	40.8%	29.4%	29.0%	29.0%
Total debt	509	3,584	3,584	3,334	Net margin	12.4%	15.6%	17.1%	18.6%
Total liabilities	2,221	5,200	5,208	4,968					
Shareholders' equity	4,041	894	1,494	2,266	Debt / EBITDA	-	-	-	-
					Debt / Capital (book)	8.0%	59.0%	53.0%	46.0%
Net income (including charges)	436	702	813	932	Return on assets (ROA)	0.0%	0.0%	0.0%	0.0%
D&A	200	150	120	120	Return on equity (ROE)	0.0%	0.0%	0.0%	0.0%
Change in working capital	(149)	94	191	65	Return on invested capital (ROIC)	-	-	-	-
Other									
Cash flow from operations	454	754	1,052	1,110	Enterprise value / sales	-	-	-	-
					Enterprise value / EBITDA	-	-	-	-
Capex	(126)	(170)	(135)	(120)	Free cash flow yield	-	3.4%	5.3%	5.7%
Free cash flow	328	584	917	990					
Cash flow from investing activities	(135)	(170)	(135)	(120)					
Cash flow from financing activities	(78)	(582)	(142)	(403)					
Dividends	-	-	-	-					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

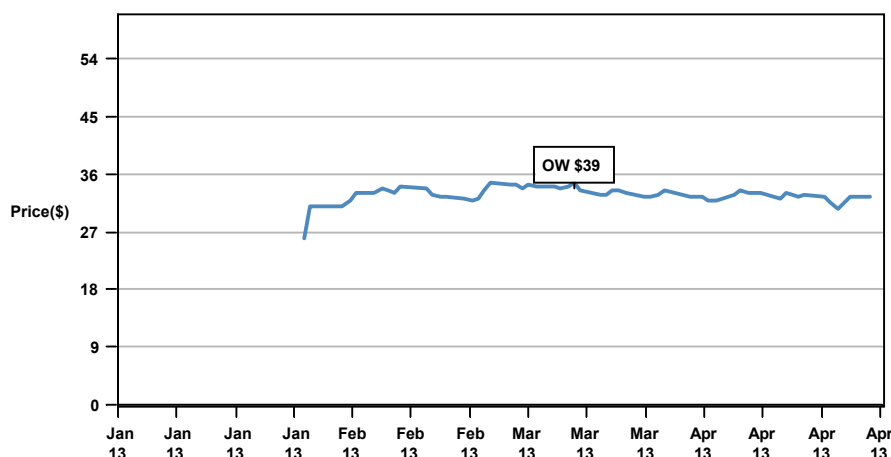
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Zoetis (ZTS, ZTS US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
13-Mar-13	OW	33.82	39.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 13, 2013.

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JPMS Equity Research Coverage	42%	50%	9%
IB clients*	74%	64%	57%

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