Medical Devices & Supplies: Animal Health Sector

Required disclosures at the end of this report

July 19, 2013

INDUSTRY OVERVIEW

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Virbac and Vetoquinol Q2 Sales Provide Incremental Insight into Animal Pharmaceutical Industry Growth Trends

- The Q2 revenue performance of Virbac and Vetoquinol provide some incremental information about recent trends in the animal pharmaceutical sector and supplements our June 18 review of Novartis Animal Health (NVS: NR). Organic revenue growth for both Virbac and Vetoquinol accelerated modestly in the quarter, though we do not view the change as significant.
- Together, Novartis, Virbac and Vetoquinol represent roughly 13% of the industry, so we do not think investors should draw overly strong conclusions about animal pharmaceutical industry performance from the results of just these three companies. Nevertheless we think their results are of some use in providing an approximate measure of recent industry trends.
- The aggregate performance of the three companies suggests to us that industry growth did not change meaningfully from Q1 to Q2. We believe Europe remains soft, but we think growth in the U.S. and emerging markets is good. The earnings reports of Eli Lilly (LLY: NR) and several other animal health companies next week should provide additional insight into the industry's recent growth trends.
- Within our coverage universe, observing animal pharmaceutical industry growth trends is most applicable to the stock of Zoetis (ZTS: SB\$41). As a foundation for our Zoetis financial projections, we are assuming stable industry growth in Q2 and the next several quarters. We view the current valuation of Zoetis as attractive and we reiterate our Strong Buy rating.

Q2 sales of Virbac and Vetoquinol provide some incremental information about recent trends in the animal pharmaceutical sector and supplements our June 18 review of Novartis Animal Health: To supplement our review of the June quarter results of Novartis' animal health division results in our June 18 industry note, we thought it would be useful to review the June quarter results of two relatively small animal pharmaceutical companies: Virbac (VIRP-PA) and Vetoquinol (VETO-PA). Virbac has approximately $900MM in annual revenues; it reported June quarter sales yesterday afternoon. Vetoquinol has approximately $400MM in annual revenues and reported June quarter sales on July 16.

Together, Novartis, Virbac and Vetoquinol have about $2.5B sales, or about 13% of the industry aggregate: In aggregate, we estimate the Novartis' animal health division, Virbac and Vetoquinol have approximately $2.5B in revenues and represent roughly 13% of the industry. Given this small share of the total market we do not think investors should draw overly strong conclusions about animal pharmaceutical industry performance from the results of just these three companies. Nevertheless, we think they are of some use in providing an approximate measure of recent industry trends and that the results of these three companies combined with Eli Lilly's (LLY: NR) results next Wednesday should provide a better view of industry trends. The three major animal health diagnostics companies also report June quarter results next week, and that should provide further information about industry performance.

The aggregate performance of the three companies suggests to us that industry growth did not change meaningfully in Q2 from Q1: Both Virbac and Vetoquinol had a slight acceleration in organic revenue growth in Q2 compared to Q1; however, we do not view their acceleration in Q2 as significant. Moreover, we note the growth rates of both companies are low and, in our view, below the industry rate. The aggregate view of Novartis Animal Health, Virbac, and Vetoquinol's Q2 revenue performance suggests to us that industry growth trends did not change materially relative to Q1. In addition, we believe industry growth in Europe remains soft but is good in the U.S. and emerging markets.

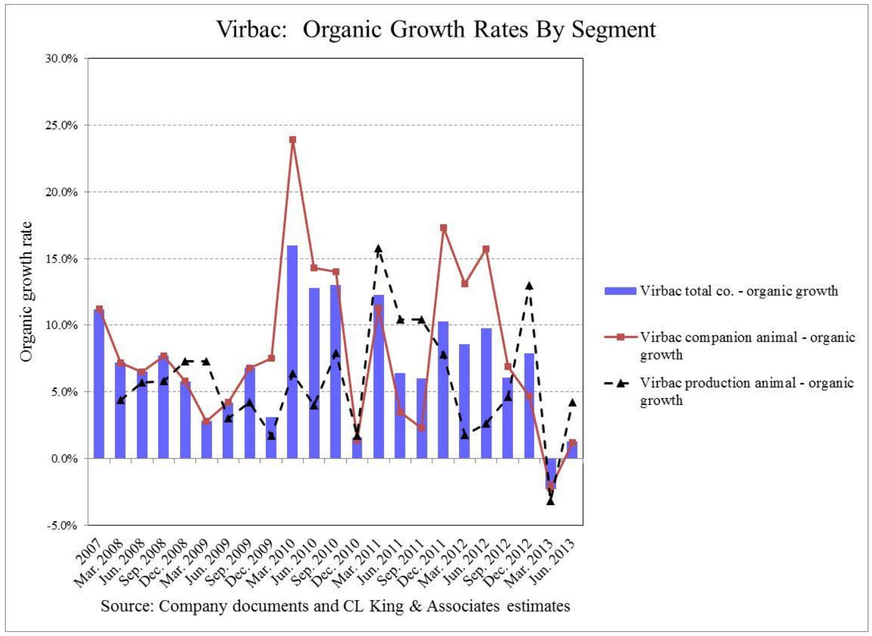
Both Virbac and Vetoquinol had a slight acceleration in revenues on a sequential basis, but we do not view it as significant: Virbac reported organic revenue growth of 1.3% in Q2 compared to (2.3)% in Q1 and Vetoquinol reported organic revenue growth of 1.4% in Q2 compared to (1.4)% in Q1. The growth rates of both the companion animal product lines and the production animal product lines of both companies improved in Q2 compared to Q1. Also, for the first six months of the year Virbac's organic growth was (0.5)% while Vetoquinol's organic growth was 0.0%. Charts 1 and 2 below show organic growth trends for both companies.

Chart 1: Virbac Organic Revenue Growth

During the first half of 2013 Virbac's sales were pressured by economic weakness in Europe; its business in Japan and Australia was also soft.

Virbac's U.S. sales increased slightly in Q2 despite the withdrawal of Iverhart Plus from the market. We believe U.S. sales were flat or up slightly in the first half of the year. Growth in emerging markets has been relatively strong in the first half of the year.

The comparison against the launch of the CaniLeish vaccine in Europe last year has contributed to a portion of Virbac's revenue deceleration in 2013.



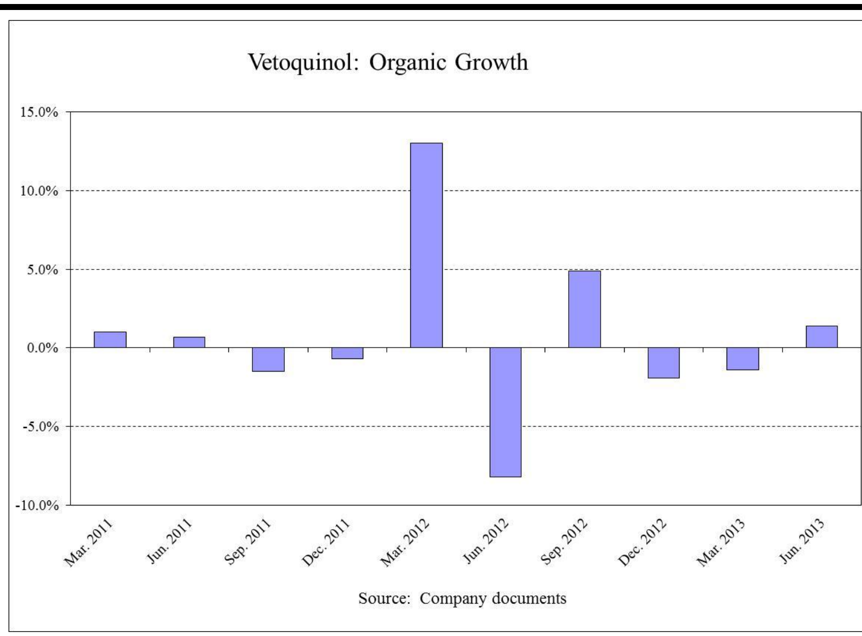
Source: Company documents and CL King & Associates estimates

Chart 2: Vetoquinol Organic Revenue Growth

As perspective, Vetoquinol's growth has trended close to flat for the last two and a half years.

The table below summarizes our estimates of the company's growth by region and animal segment.

Item	Q1:13	Q2:13
Organic growth:		
Europe	-3.2%	1.4%
Americas	0.7%	-0.1%
Asia/Pacific	5.6%	1.6%
Total	-1.4%	1.4%
Organic growth:		
Production animals	-4.2%	0.2%
Companion animals	0.4%	3.8%
Total	-1.4%	1.4%



Source: Company documents and CL King & Associates estimates

Review of our July 18 comments about Novartis' Animal Health's performance in Q2: Novartis' commentary, summarized in Table 1, suggests to us that the growth of its animal health business in the international markets did not change meaningfully in the June quarter compared to the March quarter. Given the impact of Sentinel's return on Novartis' North American animal health business, it is difficult to evaluate underlying trends in the North American animal health industry based on the company's performance in that market.

Table 1: Summary of Novartis' Commentary About Its Animal Health Performance in Q1 and Q2 of 2013

Q1:13	Q2:13
"In **Europe**, the business also delivered **mid-single-digit growth**, led by the UK and France."	"In **Europe** the business delivered **mid-single-digit growth**, led by Germany, Iberia and Italy."
"**Emerging Growth Markets** delivered **double-digit growth**, led by Russia and Brazil."	"**Emerging market**s delivered **double-digit growth**, led by Brazil, Russia, India, Thailand and Vietnam."

Source: Company documents and CL King & Associates estimates

Managements *from Abaxis (ABAX**:SB\$50, Idexx (IDXX**: SB$115), MWI Veterinary Supply (MWIV: SB\$140), Henry Schein (HSIC: B\$100), Patterson (PDCO: B\$44), Pethealth, Inc., and VCA Antech (WOOF**: N) will present at the* ***CL King Best Ideas Conference 2013*** *to be held* ***September 11 & 12*** *in New York City. Register for the conference at* http://www.meetmax.com/clking13reg.html.

Risks

Zoetis: *There are a number of potential risks that could have a negative affect on Zoetis' business and its stock. To begin, there is a risk regulators could impose new restrictions on the use of antibiotics in production animals due to concerns about antimicrobial resistance in humans. Also, the production animal and companion animal markets are sensitive to the economy, so if the economy weakens materially Zoetis' revenues and income may be lower than we project. Furthermore, severe weather conditions such as drought could negatively affect Zoetis' production animal business. For example, drought can result in higher grain and feed prices and reduce available grazing pastures, either one of which could result in a reduction of beef and dairy cattle herds. Within our financial forecasts we project Zoetis' margins should expand over the next several years. There is a risk the company may not be successful in improving margins as much as we expect. Also, the company may not be as effective as we project in managing its operations and expenses during its process of fully separating its operations from Pfizer (PFE: NR).*

Previous industry overview – 07/19/13

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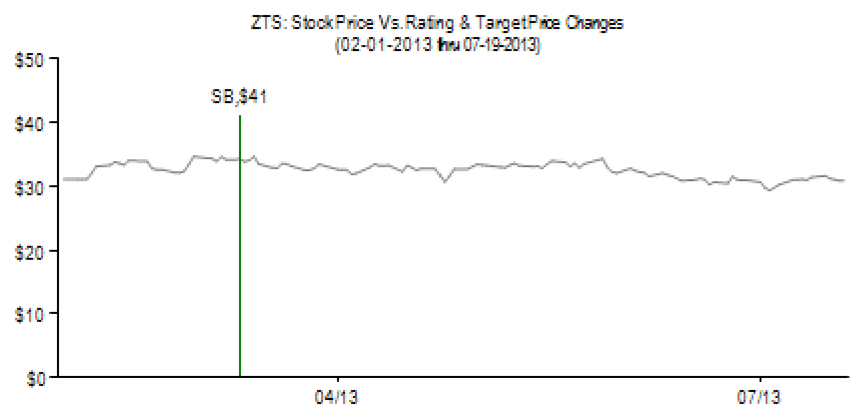
Rating and Price Target Change History



Source: CL King & Associates, Created by: wwww.ResearchMaestro.net

3 Year Rating Change History

Date	Rating	Closing Price ($)
03/11/2013	Strong Buy (SB)	34.18

3 Year Price Change History

Date	Target Price	Closing Price ($)
03/11/2013	41.00	34.18

Note: Prior to 02/01/2011 Buy was Accumulate
Prior to 02/01/2011 Sell was Underperform

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CL King Rating System*		**% of Companies Under Coverage With This Rating**	**% of Companies for which CL King has performed services for in the last 12 months**	
			Investment Banking	**Brokerage**
Strong Buy (SB)	Analyst believes shares will appreciate by 20% or more over the next 6-12 months and should significantly outperform the broader market averages. Analyst believes the risk of long-term capital impairment is below-average.	15.83%	0.00%	2.16%
Buy (B)	Analyst believes shares will appreciate in a range of 10% to the upper teens over the next 6-12 months and will outperform the broader capital market averages. Analyst believes the risk of long-term capital impairment is below-average, but not as low as it is for Strong Buy.	38.13%	1.44%	0.72%
Neutral (N)	Analyst believes the current stock price fairly discounts the company's prospects over the next 6-12 months, give or take 10%, and will trade in-line with the broader market averages. Analyst believes the risk of permanent capital impairment is about average.	45.32%	0.72%	1.44%
Sell (S)	Analyst expects the stock price to decline 10% or more over the next 6-12 months and to underperform the broader market averages.	0.72%	0.00%	0.00%

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