

Zoetis Inc. (ZTS)

Overweight

SG&A Concerns Overblown; Solid Revenue Growth Highlights Business Diversity

CONCLUSION

Better than expected revenues were highlighted by 11% growth in U.S. livestock sales and 10% growth in U.S. companion animal sales. EPS was in-line as margins were lower primarily due to promotional expenses that were delayed from Q2. ZTS also launched two beta-agonist products, one for cattle and one for swine, which we find encouraging given high interest for the products in the livestock market. FY13 EPS guidance was narrowed to \$1.38 to \$1.42 (previously \$1.36 to \$1.42). ZTS remains a long-term Top Pick as we believe top-line growth could ramp from mid-single digits to high-single digits driven by the improving cattle market, additional product introductions and successful launches, and strategic acquisitions. Maintain Overweight rating and \$39 PT.

- **Promotional spend negatively impacts margins, but expansion story still intact.** We believe concerns about higher SG&A or lack of operating leverage is overblown and believe the long-term margin expansion story is still intact. While SG&A increased 16 bps y/y (as a percentage of sales) and was 205 bps higher than our estimate, it was primarily due to promotional expenses, some of which took place in Q3 instead of Q2, as well as educating vets on new product launches, e.g. APOQUEL in early 2014. Spending can vary quarter to quarter, so management believes the company is performing on track and leverage from 2013 can be sustained in 2014. We expect operating margins to expand 192 bps in 2014 and 144 bps in 2015.
- **New product introductions should help drive growth.** ZTS highlighted a few product introductions, including U.S. approval for two branded generic ractopamine products or beta-agonists. ENGAIN, used for swine, is expected to launch in the first quarter of 2014 and ACTOGAIN, used for cattle, is expected to launch in the second half of 2014. While Merck's beta-agonist, Zilmax, was pulled from the market due to potential adverse side effects in cattle, no side effects have been reported for ZTS' new ractopamine products. We remain encouraged by ZTS' product development activities, including FACTREL for dairy cattle and the beta-agonists, which will be in high demand as ranchers look to maximize the value of their livestock.
- **Livestock and company animal trends seem favorable.** We believe trends in the livestock and companion animal markets are favorable for ZTS, particularly in the U.S., as livestock revenues increased 11% y/y and companion animal revenues increased 10%. ZTS noted September cattle trends were positive and are anticipated to improve in October, despite lower year-over-year cattle placements in Q3. The most recent USDA Cattle on Feed report indicates placements increased 1%, which we expect to continue next month as cattle are moved from pasture to the feedlots.

RISKS TO ACHIEVEMENT OF PRICE TARGET

Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

COMPANY DESCRIPTION

Zoetis is the leading global manufacturer of animal health medications and vaccines.

PRICE: US\$31.69

TARGET: US\$39.00

(24.5x FY14E EPS)

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	US\$4,495.8	US\$4,516.2
FY14E Rev (mil)	US\$4,733.0	US\$4,751.5
FY13E EPS	—	US\$1.40
FY14E EPS	—	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.0	
Market Cap. (mil)	US\$15,845.0	
Avg Daily Vol (ooo)	4,201	
Book Value/Share	US\$1.45	
Net Cash Per Share	US\$0.00	
Debt to Total Capital	83%	
Div (ann)	US\$0.26	
Yield	0.82%	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2012A	1,047.0	1,094.0	1,019.0	1,176.0	4,336.0	3.7x	0.30	0.35	0.31	0.11	1.08	29.3x
2013E	1,090.0A	1,114.0A	1,103.0A	1,209.2	4,516.2	3.5x	0.36A	0.36A	0.34A	0.34	1.40	22.6x
2014E	1,142.2	1,172.0	1,166.5	1,270.8	4,751.5	3.3x	0.40	0.39	0.40	0.40	1.59	19.9x

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Period	FY09	FY10	FY11	1Q12	2Q12	3Q12	4Q12	FY12	1Q13	2Q13	3Q13	4Q13E	FY13E	1Q14E	2Q14E	3Q14E	4Q14E	FY14E	FY15E
Ending	12/31/09	12/31/10	12/31/11	3/31/12	6/30/12	9/30/12	12/31/12	12/31/12	3/31/13	6/30/13	9/30/13	12/31/13	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	12/31/14	12/31/15
Revenues	\$2,760.0	\$3,582.0	\$4,233.0	\$1,047.0	\$1,094.0	\$1,019.0	\$1,176.0	\$4,336.0	\$1,090.0	\$1,114.0	\$1,103.0	\$1,209.2	\$4,516.2	\$1,142.2	\$1,172.0	\$1,166.5	\$1,270.8	\$4,751.5	\$5,012.6
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	4.1%	1.8%	8.2%	2.8%	4.2%	4.8%	5.2%	5.8%	5.1%	5.2%	5.5%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-7.3%	2.2%	-1.0%	9.6%		-5.5%	2.6%	-0.5%	8.9%		
Cost of sales	1,001.0	1,318.0	1,581.0	388.0	382.0	352.0	\$427.0	1,549.0	398.0	400.0	383.0	426.9	1,607.9	410.6	416.1	399.5	435.3	1,661.4	1,727.6
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	692.0	714.0	720.0	782.4	2,908.4	731.6	756.0	767.0	835.6	3,090.0	3,284.9
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	63.49%	64.09%	65.28%	64.70%	64.40%	64.05%	64.50%	65.75%	65.75%	65.03%	65.53%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	322.0	339.0	359.0	402.1	1,422.1	331.2	356.3	361.6	406.7	1,455.8	1,508.2
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	90.0	91.0	91.0	111.9	383.9	91.4	94.9	96.2	115.6	398.2	403.8
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	3.0	4.0	3.0	14.0	3.5	3.5	3.5	3.5	14.0	14.0
Restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other expenses/(income)	(1.0)	(25.0)	(28.0)	(6.0)	(7.0)	(10.0)	2.0	(21.0)	2.0	(3.0)	(7.0)	(5.0)	(13.0)	(7.0)	(7.0)	(7.0)	(7.0)	(28.0)	(32.0)
Total operating expenses	1,437.0	1,768.0	1,846.0	422.0	438.0	418.0	567.0	1,845.0	418.0	430.0	447.0	511.9	1,806.9	419.1	447.7	454.3	518.8	1,840.0	1,894.0
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	274.0	284.0	273.0	270.4	1,101.4	312.5	308.2	312.6	316.8	1,250.1	1,390.9
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	25.14%	25.49%	24.75%	22.37%	24.39%	27.36%	26.30%	26.80%	24.93%	26.31%	27.75%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	22.0	32.0	29.0	29.5	112.5	30.0	30.0	30.0	30.0	120.0	120.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	252.0	252.0	244.0	240.9	988.9	282.5	278.2	282.6	286.8	1,130.1	1,270.9
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	23.12%	22.62%	22.12%	19.93%	21.90%	24.73%	23.74%	24.23%	22.56%	23.78%	25.35%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	73.0	74.0	72.0	71.1	290.1	83.3	82.1	83.4	84.6	333.4	374.9
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	28.97%	29.37%	29.51%	29.50%	29.33%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%
Net Income	188.0	276.0	506.0	153.0	176.0	153.0	57.0	539.0	179.0	178.0	172.0	169.9	698.9	199.1	196.2	199.2	202.2	796.7	896.0
less: net income attributable to noncont	(1.0)	1.0	3.0	1.0	0.0	(1.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income attributable to Zoetis	189.0	275.0	503.0	152.0	176.0	154.0	57.0	539.0	179.0	178.0	172.0	169.9	698.9	199.1	196.2	199.2	202.2	796.7	896.0
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	16.42%	15.98%	15.59%	14.05%	15.47%	17.43%	16.74%	17.08%	15.91%	16.77%	17.87%
Diluted EPS	\$0.38	\$0.55	\$1.01	\$0.30	\$0.35	\$0.31	\$0.11	\$1.08	\$0.36	\$0.36	\$0.34	\$0.34	\$1.40	\$0.40	\$0.39	\$0.40	\$0.40	\$1.59	\$1.79
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.1	500.2	500.0	500.0	500.1	500.0	500.0	500.0	500.0	500.0	500.0
Dividend			\$0.83	\$0.104	\$0.020	\$0.002	\$0.000	\$0.13	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.26
Dividend yield									0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Payout			82.7%	34.2%	5.7%	0.6%	0.0%	11.7%	0.0%	18.5%	18.9%	19.1%	14.0%	16.3%	16.6%	16.3%	16.1%	16.3%	14.5%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.51%	35.91%	34.72%	35.30%	35.60%	35.95%	35.50%	34.25%	34.25%	34.97%	34.47%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	29.54%	30.43%	32.55%	33.25%	31.49%	29.00%	30.40%	31.00%	32.00%	30.64%	30.09%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.26%	8.17%	8.25%	9.25%	8.50%	8.00%	8.10%	8.25%	9.10%	8.38%	8.06%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	38.35%	38.60%	40.53%	42.33%	40.01%	36.69%	38.20%	38.95%	40.82%	38.72%	37.79%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.21%	3.41%	3.25%	3.25%	3.28%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%
Yr/Yr Growth:																			
Cost of Sales		31.7%	20.0%	5.4%	-10.5%	-9.7%	7.8%	-2.0%	2.6%	4.7%	8.8%	0.0%	3.8%	3.2%	4.0%	4.3%	2.0%	3.3%	4.0%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	5.0%	0.3%	7.9%	4.5%	4.4%	5.7%	5.9%	6.5%	6.8%	6.2%	6.3%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	-2.7%	-3.4%	8.8%	-8.6%	-2.1%	2.9%	5.1%	0.7%	1.1%	2.4%	3.6%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-3.2%	0.0%	-3.2%	-7.6%	-3.8%	1.5%	4.3%	5.8%	3.4%	3.7%	1.4%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	15.6%	3.6%	9.6%	48.6%	16.9%	14.0%	8.5%	14.5%	17.1%	13.5%	11.3%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	10.0%	-5.3%	0.8%	38.5%	8.6%	12.1%	10.4%	15.8%	19.0%	14.3%	12.5%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.8%	1.1%	11.7%	198.0%	29.7%	11.2%	10.2%	15.8%	19.0%	14.0%	12.5%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.7%	1.1%	11.7%	198.0%	29.6%	11.3%	10.2%	15.8%	19.0%	14.0%	12.5%

Source: Company reports and Piper Jaffray & Co. Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

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D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
N: Neutral
UW: Underweight
NA: Not Available
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	338	57.09	75	22.19
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