

Zoetis Inc. (ZTS)

Overweight

Getting Ready For The Q2 Animal Pharm; Maintain Overweight

CONCLUSION

ZTS remains one of our top large cap ideas because of its industry-leading position and long-term growth opportunities. Following the conclusion of the share exchange with PFE, the stock has been relatively weak and we believe there are some concerns about Q2 earnings due to the impact from last year's drought and potential weakness in European flea & tick. That said, we remain confident that ZTS will report solid Q2 results as the drought headwind is appropriately accounted for in estimates and the U.S. companion animal business is expected to be good this quarter. Maintain Overweight rating and \$39 PT.

- **Expect solid Q2 results, which will alleviate some concerns.** Recently shares of ZTS have been relatively weak following the PFE share exchange. We believe Q2 earnings could be a catalyst to reignite the stock as it would provide confidence that the production animal business is performing in line with expectations. Heading into the Q2 print on August 6th, we are projecting EPS of \$0.36, which is in line with consensus, on revs of \$1,129 MM, which compares to consensus of \$1,131 MM.
- **Long-term fundamental story intact.** The recent pullback in the stock has created an attractive buying opportunity, in our view, as the share exchange with PFE removed an overhang. We continue to believe ZTS' long-term opportunity is attractive for the following reasons:
 - **Recent drug approvals with more on the way.** Following FDA approval in May, APOQUEL is expected to launch in 1Q14 and depending on price and uptake from vets, we believe APOQUEL could reach blockbuster status (> \$100 MM) over the next few years and could generate EPS of \$0.02-\$0.06 assuming revenues of \$50-\$150 MM. FDA also recently approved FACTREL® for use with LUTALYSE® for fixed-time artificial insemination in dairy cows. Now that ZTS is a stand-alone entity, we believe there could be additional pharmaceutical partnerships to develop new animal health products.
 - **Continued margin expansion and cost rationalization.** We believe operating margin expansion will be driven by incremental pricing growth, continued focus on manufacturing efficiencies, and disciplined SG&A spending. In 1Q13, operating margins expanded by 250bps and we estimate every 50bps of operating margin expansion could add \$0.03 to EPS.
 - **Capital deployment.** We believe the company could start to look at acquisition opportunities as another source of growth. Since diagnostics is the fastest growing segment in the animal health industry, we would not be surprised if ZTS expands its capabilities on top of its Synbiotics business.

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\$30.92

TARGET: US\$39.00

(24.5x FY14E EPS)

Kevin K. Ellich

Sr Research Analyst, Piper Jaffray & Co.
612 303-5666, kevin.k.ellich@pjc.com

Bradley D. Maier

Research Analyst, Piper Jaffray & Co.
612 303-6646, bradley.d.maier@pjc.com

Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	—	US\$4,508.9
FY14E Rev (mil)	—	US\$4,745.1
FY13E EPS	—	US\$1.40
FY14E EPS	—	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.1	
Market Cap. (mil)	US\$15,463.1	
Avg Daily Vol (ooo)	7,457	
Book Value/Share	US\$8.08	
Net Cash Per Share	US\$0.53	
Debt to Total Capital	75%	
Div (ann)	US\$0.26	
Yield	0.84%	
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	3.6x	0.30	0.35	0.31	0.11	1.08	28.6x
2013E	1,090.0A	1,128.9	1,061.2	1,228.7	4,508.9	3.4x	0.36A	0.36	0.34	0.34	1.40	22.1x
2014E	1,138.7	1,189.7	1,122.4	1,294.3	4,745.1	3.3x	0.39	0.40	0.39	0.41	1.59	19.4x

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PJC Estimates vs. Consensus

We expect ZTS to report solid 2Q13 results that meet or slightly beat consensus estimates. We are currently projecting 2Q13 EPS of \$0.36 on revenues of \$1,129 MM, which is in-line with consensus. We believe an in-line quarter could help alleviate investor concerns about the drought and its effect on the production animal business. Additionally, we note U.S. revenue growth comps get easier in the back half of the year. The U.S. region is the largest revenue component of the business as it accounts for approximately 42% of total revenues.

Exhibit 1

PJC ESTIMATES VS. CONSENSUS

\$'s in millions, except per share

ZTS 2Q13 Estimates vs. Consensus			ZTS FY13 Estimates	
	Revenues	EPS	Revenue	EPS
PJC	\$1,128.9	\$0.36	\$4,509.0	\$1.40
Street	\$1,131.0	\$0.36	\$4,519.0	\$1.40

Source: Piper Jaffray estimates, FactSet, Company reports

Exhibit 2

US & EUAFME REVENUE COMPS

	Historical Base Growth			PJC Est. Base Growth		
	2Q12	3Q12	4Q12	2Q13E	3Q13E	4Q13E
U.S. Rev. Growth	7.7%	2.3%	5.0%	4.0%	4.5%	5.0%
EuAfMe Rev. Growth	3.3%	-1.0%	6.0%	3.0%	3.0%	4.0%

Source: Piper Jaffray estimates, Company reports

Margin Expansion Opportunity Remains Intact

We continue to see significant operating margin expansion over the next several years as ZTS focuses on rationalizing costs as a stand-alone company. We believe operating margin expansion will be driven by incremental pricing growth, continued focus on manufacturing efficiencies, and disciplined SG&A spending. We are currently projecting operating margins to increase by 278 bps in 2013, 185 bps in 2014 and 127 bps in 2015. We estimate every 50 bps of operating margin expansion could add an incremental \$0.03 to annual EPS.

Exhibit 3

OPERATING MARGINS

	FY12	1Q13	FY13E	FY14E	FY15E
Adj. Operating Margin	21.73%	25.14%	24.50%	26.35%	27.62%
y/y change (bps)	2.69%	2.50%	2.77%	1.85%	1.27%

Source: Piper Jaffray estimates, Company reports

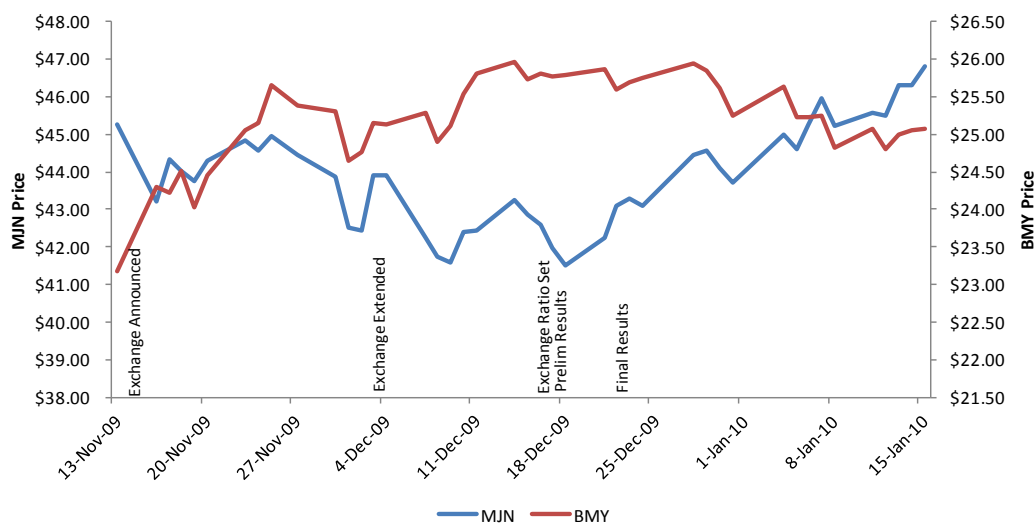
**Another Share
Exchange For
Comparison –
BMJ/MJN**

Now that the share exchange with Pfizer (PFE) is complete, we thought it would be a good idea to look at a comparison with another spinout of a pharmaceutical company, which also included a share exchange. In late 2009, Bristol-Myers Squibb (BMY) and Mead Johnson (MJN) conducted a similar exchange offering after MJN was spun-out of BMY through an IPO. At the time, BMY owned 170,000,000 shares of MJN class A and class B common stock, which represented 97.5% of the voting interest and 83.1% of the economic interest in MJN. The initial terms were for each \$1.00 of BMY stock accepted in the exchange offering, the tendering shareholder received approximately \$1.11 of MJN common stock, subject to the upper limit exchange ratio of 0.6027 shares of MJN common stock per share of BMY common stock. Subsequently, the upper limit exchange ratio was changed to 0.6313 and the exchange was extended. When the exchange closed the upper limit was in effect and the offering was oversubscribed. BMY accepted 269,285,601 shares in the exchange offering for 170,000,000 shares of MJN common stock that was owned by BMY. While this exchange offering is not exactly the same as the PFE/ZTS exchange, we believe it is a good frame of reference in regards to the process and also to illustrate how the stocks reacted throughout the exchange.

The chart in Exhibit 4 displays the stock prices for BMY and MJN during the exchange offering. We think it is important to note that when the exchange offering was announced, MJN traded down much like ZTS, but after the exchange ratio was set and the preliminary results were announced, MJN traded higher the following month. That said, we believe further downside in ZTS is limited and expect the stock to recover over the next few weeks, all else held equal.

Exhibit 4

BMJ AND MJN PRICE DURING EXCHANGE OFFERING



Source: FactSet and Company Website

Period	FY09	FY10	FY11	1Q12	2Q12	3Q12	4Q12	FY12	1Q13	2Q13E	3Q13E	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	\$1,128.9	\$1,061.2	\$1,228.7	\$4,508.9	\$1,138.7	\$1,189.7	\$1,122.4	\$1,294.3	\$4,745.1	\$4,995.5
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	4.1%	3.2%	4.1%	4.5%	4.0%	4.5%	5.4%	5.8%	5.3%	5.2%	5.3%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-7.3%	3.6%	-6.0%	15.8%		-7.3%	4.5%	-5.7%	15.3%		
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	404.7	371.4	430.1	1,604.2	409.9	420.6	384.4	443.3	1,658.2	1,719.5
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	692.0	724.2	689.8	798.7	2,904.7	728.8	769.1	738.0	851.0	3,086.9	3,276.0
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	63.49%	64.15%	65.00%	65.00%	64.42%	64.00%	64.65%	65.75%	65.75%	65.05%	65.58%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	322.0	350.0	327.9	406.7	1,406.6	333.1	362.9	340.1	415.5	1,451.5	1,507.1
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	90.0	93.1	92.3	121.6	397.1	92.8	95.2	93.2	117.8	398.9	405.1
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	4.0	4.0	4.0	16.0	4.0	4.0	4.0	4.0	16.0	16.0
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	(7.3)	(7.3)	(7.3)	(19.8)	(7.5)	(7.5)	(7.5)	(7.5)	(30.0)	(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	439.9	417.0	525.1	1,800.0	422.4	454.5	429.8	529.7	1,836.4	1,896.2
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	274.0	284.4	272.8	273.6	1,104.7	306.4	314.6	308.2	321.2	1,250.5	1,379.8
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	25.14%	25.19%	25.71%	22.26%	24.50%	26.91%	26.44%	27.46%	24.82%	26.35%	27.62%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	22.0	31.0	31.0	31.0	115.0	31.0	31.0	31.0	31.0	124.0	120.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	252.0	253.4	241.8	242.6	989.7	275.4	283.6	277.2	290.2	1,126.5	1,259.8
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	23.12%	22.44%	22.79%	19.74%	21.95%	24.18%	23.84%	24.70%	22.43%	23.74%	25.22%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	73.0	74.1	71.9	72.8	291.8	81.2	83.7	81.8	85.6	332.3	371.6
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	28.97%	29.25%	29.75%	30.00%	29.48%	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	179.2	169.9	169.8	697.9	194.2	199.9	195.5	204.6	794.2	888.2
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	179.2	169.9	169.8	697.9	194.2	199.9	195.5	204.6	794.2	888.2
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	16.42%	15.88%	16.01%	13.82%	15.48%	17.05%	16.81%	17.41%	15.81%	16.74%	17.78%
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	\$0.39	\$0.40	\$0.39	\$0.41	\$1.59	\$1.78
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.1	500.0	500.0	500.0	500.0	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%	18.1%	19.1%	19.1%	14.0%	16.7%	16.3%	16.6%	15.9%	16.4%	14.6%
Depreciation and amortization	103.0	122.0	137.0	32.9	37.0	37.0	30.1	137.0	35.0	36.7	34.5	39.9	146.1	37.6	39.3	37.0	42.7	156.6	164.9
Adjusted EBITDA	426.0	617.0	940.0	268.9	311.0	287.0	212.1	1,079.0	309.0	321.0	307.3	313.5	1,250.8	344.0	353.9	345.3	364.0	1,407.1	1,544.7
Adjusted EBITDA Margin	15.43%	17.23%	22.21%	25.68%	28.43%	28.16%	18.04%	24.88%	28.35%	28.44%	28.96%	25.51%	27.74%	30.21%	29.74%	30.76%	28.12%	29.65%	30.92%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.51%	35.85%	35.00%	35.00%	35.58%	36.00%	35.35%	34.25%	34.25%	34.95%	34.42%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	29.54%	31.00%	30.90%	33.10%	31.20%	29.25%	30.50%	30.30%	32.10%	30.59%	30.17%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.26%	8.25%	8.70%	9.90%	8.81%	8.15%	8.00%	8.30%	9.10%	8.41%	8.11%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	38.35%	38.96%	39.29%	42.74%	39.92%	37.09%	38.21%	38.29%	40.93%	38.70%	37.96%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.21%	3.25%	3.25%	3.25%	3.24%	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%	5.9%	5.5%	0.7%	3.6%	3.0%	3.9%	3.5%	3.1%	3.4%	3.7%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	5.0%	1.7%	3.4%	6.6%	4.2%	5.3%	6.2%	7.0%	6.6%	6.3%	6.1%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	-2.7%	-0.3%	-0.6%	-7.6%	-3.1%	3.4%	3.7%	3.7%	2.2%	3.2%	3.8%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-3.2%	2.3%	-1.8%	0.5%	-0.5%	3.1%	2.2%	0.9%	-3.2%	0.5%	1.6%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	15.6%	3.8%	9.6%	50.3%	17.3%	11.8%	10.6%	13.0%	17.4%	13.2%	10.3%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	10.0%	-4.8%	-0.1%	39.4%	8.6%	9.3%	11.9%	14.7%	19.7%	13.8%	11.8%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.8%	1.8%	10.3%	197.9%	29.5%	8.5%	11.5%	15.1%	20.5%	13.8%	11.8%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.7%	1.8%	10.3%	197.9%	29.5%	8.5%	11.5%	15.1%	20.5%	13.8%	11.8%

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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IMPORTANT RESEARCH DISCLOSURES



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I: Initiating Coverage
R: Resuming Coverage
T: Transferring Coverage
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]	348	58.19	69	19.83
HOLD [N]	220	36.79	11	5.00
SELL [UW]	30	5.02	0	0.00

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Analyst Certification — Kevin K. Ellich, Sr Research Analyst

— Bradley D. Maiers, Research Analyst

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- **Overweight (OW):** Anticipated to outperform relative to the median of the group of stocks covered by the analyst.
- **Neutral (N):** Anticipated to perform in line relative to the median of the group of stocks covered by the analyst.
- **Underweight (UW):** Anticipated to underperform relative to the median of the group of stocks covered by the analyst.

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