HILLIARD LYONS

Pharmaceuticals
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Zoetis, Inc.

ZTS – NYSE – Buy – 3

COMPANY UPDATE
(November 5, 2013)

Key Metrics

ZTS - NYSE (Price as of 11/4/13)		$31.93
Price Target		$36.00
52-Week Range		$35.42 - $28.81
Shares Outstanding (mm)		500.0
Market Cap. ($mm)		$15,965
3-Mo. Average Daily Volume		4,635,070
Institutional Ownership		97.0%
Tot. Debt/Tot. Debt+Equity (6/13)		81.6%
ROE (2012)		NA
Book Value/Share		$1.60
Price/Book Value (11/4/13)		19.90x
Indicated Dividend / Yield	$0.26	0.8%
LTM EBITDA Margin		25.7%

EPS FY 12/31

	Pro-forma 2012	Prior 2013E	Curr. 2013E	Prior 2014E	Curr. 2014E
1Q	--	$0.36A	$0.36A	--	--
2Q	--	$0.36A	$0.36A	--	--
3Q	--	--	$0.34A	--	--
4Q	--	--	--	--	--
Year	$0.97	$1.40	$1.40		$1.60
P/E	32.9x	22.8x	22.8x		20.0x

Note: Figures exclude non-recurring items

Revenue ($mm)

	2012	Prior 2013E	Curr. 2013E	Prior 2014E	Curr. 2014E
1Q	$1,047	$1,090A	$1,090A	--	--
2Q	$1,094	$1,114A	$1,114A	--	--
3Q	$1,019	--	$1,103A	--	--
4Q	$1,176	--	--	--	--
Year	$4,336	$4,500	$4,500		$4,725

Company Description: *Zoetis operates the world's largest animal health business. Zoetis is involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals. The company sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific.*

Broad-based Worldwide Revenue Growth

- **Zoetis, a global leader in the development, manufacture, and marketing of animal health medicines and vaccines, was separated from Pfizer in June 2013**. ZTS's over 300 product lines focus on livestock, including cattle, poultry, swine, sheep, and fish, as well as companion animals. Key products are vaccines, parasiticides, anti-infectives, and other specialty products. More than 3,400 sales representatives serve livestock producers and veterinarians in 70 countries.
- **Zoetis reported solid revenue growth for the third quarter**. Third quarter revenue increased 8% to $1.10 billion from $1.02 billion in the third quarter of 2012. Currency reduced revenue growth by 1%.
- **Sales grew in all regions**. U.S. revenue increased 11% versus a weak period last year caused by the drought. Europe, Africa, and the Middle East increased 12%. Canada and Latin America rose 4%. Sales in Asia were up only 1%, held back by currency.
- **Both livestock and companion animal sales rose**. Livestock revenue grew 7% to $706 million on growth in cattle, poultry, and swine products. Companion animal sales rose 10% to $393 million with double-digit growth in sales of products for dogs and cats.
- **Earnings for the quarter met expectations**. Despite faster SG&A spending, the third quarter operating margin of 24.1% improved from 23.5% a year ago. EPS of $0.34, excluding non-recurring items, rose 12% from $0.31 last year and matched consensus expectations of $0.34.
- **Management narrowed revenue and earnings guidance for 2013**. Revenue for 2013 could be $4.475 to $4.525 billion with adjusted EPS in a range of $1.38 to $1.42. We have maintained our revenue forecast at $4.5 billion. Our 2013 EPS estimate is $1.40.
- **Zoetis is rated Buy.** ZTS is the first major participant in the global animal health business available to those interested in investing in the sector. ZTS is trading at 23 times our 2013 EPS estimate. Our price target is $36 per share.

Note Important Disclosures on Page 7 and 8.
Note Analyst Certification on Page 7.

Strategic Alternatives for Pfizer's Animal Health and Nutrition Units

Pfizer completed the strategic repositioning of its animal health and nutrition businesses. Management noted these were strong franchises on their own, but had different objectives from PFE's core pharmaceutical businesses. As such, their strategic direction and value to Pfizer shareholders might be maximized by a spin-off, sale, or other transaction. Separation allows Pfizer to focus on its global pharmaceutical and consumer medicines areas. In December 2012, Pfizer completed the sale of its nutrition unit for $11.85 billion.

In February 2013, Pfizer completed an initial public offering of a portion of Zoetis, its former animal health business. A minority stake in the unit was sold through the IPO. As part of the IPO, Pfizer exchanged Zoetis Class A common stock for Pfizer debt held by certain underwriters, who then sold the shares to the public. The stock was priced at $26 per share on the public offering. Trading began on February 1, 2013. PFE retained approximately 80% ownership in the company. In June 2013, PFE distributed its remaining ownership to shareholders in a split-off transaction in which shares in Pfizer were exchanged for ZTS stock, essentially accomplishing a share repurchase.

Overview of Zoetis

Zoetis operates the world's largest animal health business. Zoetis has been involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals for more than 60 years. The business sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific. International operations accounted for 59% of total 2012 revenue – Europe, Africa, and the Middle East (25%), Canada and Latin America (18%), and Asia Pacific (16%). Sales in emerging markets such as Brazil, China, and India amounted to 26% of revenue. Products are used in the livestock species of cattle, swine, poultry, sheep, and fish. In companion animals, the company makes products for dogs, cats, and horses.

Zoetis has a sales organization of approximately 3,400 employees. The organization consists of a network of technical and veterinary operations specialists. These individuals market the company's diverse portfolio of more than 300 products to livestock producers and veterinarians in 70 countries. No one product or line dominates Zoetis' sales. The company's largest product line, the antibiotic ceftiofur, accounts for less than 8% of revenue with Zoetis' top ten products accounting for less than 40% of sales. The company generally uses a direct sales model, but engages distributors in markets without a commercial presence.

Third Quarter Results

Zoetis reported financial results for the third quarter of 2013. Results are compared to figures a year ago if ZTS had been separate from PFE at that time.

Third quarter revenue increased 8% to $1.10 billion from $1.02 billion in the third quarter of 2012 with currency a 1% drag on growth. Livestock revenue increased 7% to $706 million from $659 million last year. High single-digit growth was achieved in products for cattle and poultry with swine up 11%. Companion Animal sales were up 10% to $397 million versus $360 million. Products for dogs and cats grew 11% in the quarter while sales of equine products increased 6%.

Figure 1. Third Quarter 2013 Results
(figures in millions except per share amounts and percentages)

	Third Quarter Ended			Nine Months Ended		
	Sept. 30 2013	Sept. 30 2012	% Chg.	Sept. 30 2013	Sept. 30 2012	% Chg.
Livestock	$ 706	$ 659	7.1%	$2,082	$2,015	3.3%
Companion Animal	397	360	10.3%	1,225	1,145	7.0%
Total Revenue	1,103	1,019	8.2%	3,307	3,160	4.7%
Cost of Goods Sold	387	356	8.7%	1,192	1,133	5.2%
Gross Profit	716	663	8.0%	2,115	2,027	4.3%
Sell., Gen'l. & Admin.	359	330	8.8%	1,020	1,012	0.8%
Research & Develop.	91	94	(3.2%)	272	278	(2.2%)
Total Expenses	450	424	6.1%	1,292	1,290	0.2%
Operating Income	266	239	11.3%	823	737	11.7%
Interest Expense	(29)	(7)	- -	(83)	(23)	- -
Other Income/(Deductions)	7	10	- -	8	23	- -
Income before Taxes and Min. Interests	244	242	0.8%	748	737	1.5%
Income Taxes	72	89	(19.1%)	219	255	(14.1%)
Minority Interest	0	(1)	- -	0	0	- -
Net Income	$172	$154	11.7%	$529	$482	9.8%
Diluted EPS	$0.34	$0.31	11.6%	$1.06	$0.96	9.7%
Avg. Number of Common Shares Outstanding	500.4	500.0	0.1%	500.2	500.0	0.0%
Gross Margin	64.91%	65.06%		63.96%	64.15%	
Sell., Info. & Admin.	32.55%	32.38%		30.84%	32.03%	
Research & Develop.	8.25%	9.22%		8.22%	8.80%	
Operating Margin	24.12%	23.45%		24.89%	23.32%	
Tax Rate	29.51%	36.78%		29.28%	34.60%	
United States	495	448	10.5%	1,386	1,294	7.1%
Europe/Africa/Mid. East	270	241	12.0%	838	799	4.9%
Canada/Latin America	171	165	3.6%	555	549	1.1%
Asia/Pacific	167	165	1.2%	528	518	1.9%
Total	$1,103	$1,019	8.2%	$3,307	$3,160	4.7%

Note: Figures are from continuing operations and exclude non-recurring items
Source: Company reports

Adjusted for non-recurring items, operating income rose 11% in the quarter. The gross margin was lower at 64.9% versus 65.1% due to product and geographic mix effects. SG&A rose 9% as the company incurred added expenses to develop infrastructure as a standalone company and increased promotional spending in some areas, partially offset by cost management. Research spending was down 3% at 8.3% of revenue. Interest expense was much higher due to debt issued as part of the separation, so pretax income on the same basis increased only 1%. Adjusted net income rose 12% on a lower tax rate. EPS of $0.34, excluding non-recurring items, rose 12% from $0.31 last year and matched expectations of $0.34. SG&A was a bit more than we expected and likely prevented ZTS from exceeding expectations.

Non-recurring items impacted reported results. In the most recent quarter there were costs associated with the separation ($41 million), restructuring charges ($3 million), and amortization of intangible assets ($11 million), among other small items. A year ago, there were restructuring charges ($7 million), amortization of intangible assets ($12 million), and others. Including these items, reported EPS of $0.26 in the third quarter of 2013 compared to $0.32 last year.

By geography, U.S. sales rose 10% to $495 million from $448 million a year ago. Companion Animal sales increased 10% to $220 million. Sales growth of small animal products was strong and price increases aided growth. Zoetis launched *Apoquel* for treating allergic dermatitis in dogs. Livestock revenue was up a strong 11% to $275 million versus a relatively weak comparison with business impacted by the North American drought last year and its effect on domestic livestock producers. Price increases appear to be holding. Separately, *Bovi-Shield Gold One Shot*, a vaccine for respiratory diseases in cattle, was approved in the U.S. and Canada. *Factrel* was approved with *Lutalyse* in the U.S. for artificial insemination in dairy cattle. The FDA also approved *Excenel RTU EZ*, an antibiotic reformulated for easier use. Two products containing the feed additive ractopamine were approved in the U.S., and will be launched as *Engain* for swine and *Actogain* for cattle in 2014.

Revenue from Europe, Africa, and the Middle East was up 12% to $270 million as currency added 3% to growth. Livestock sales rose 9% to $178 million due to higher sales of cattle products in emerging markets, partially offset by a decline in Western Europe. Swine products benefited from sales of a new vaccine. Companion Animal revenue increased 18% to $92 million aided by increased sales as part of third party manufacturing agreements.

Sales in Canada and Latin America increased 4% to $171 million, but rose 9% in local currencies. Brazil and Canada are the largest markets in this region with well developed livestock industries. Livestock sales rose 1% to $129 million in part due to higher sales of poultry products in Brazil. Sales of cattle products increased in Venezuela, Mexico, and Canada. The swine vaccine *Fostera PCV* for Porcine Circovirus Type 2 was approved in Brazil. ZTS signed an agreement with a large cattle producer in Argentina to use *Clarifide* technology for genomic testing for better management of their herds. Companion Animal Sales rose 14% to $42 million due to increased demand from marketing programs in Brazil and Mexico, higher prices, and strong sales of parasiticides due to a later start to the season in Canada, which had held back second quarter sales there.

In Asia Pacific, revenue was $167 million, up 1% and up 7% in local currencies. Livestock sales rose 3% to $124 million due to strong sales of new products for swine. Poultry sales were higher in emerging markets. The drought in southern Australia impacted cattle product sales, but this was more than offset by growth in New Zealand. ZTS launched the injectable antibiotic *Draxxin* in Japan during the quarter while the swine vaccine *Fostera PCV* for Porcine Circovirus Type 2 was approved in Japan. The company's joint venture in China received approval for *Rui Lan An*, a vaccine for porcine reproductive and respiratory syndrome. Companion Animal sales were down 4% at $43 million, but rose 3% in local currencies. In March, the company launched *Convenia*, an antibiotic for companion animals in China. *Convenia*, for use against bacterial skin infections, is a well established product sold in 50 countries. Sales were also strong in Japan and Taiwan.

Financial

Balance sheet figures reflect the transactions with Pfizer as part of the separation. Zoetis issued $3.64 billion in debt in order to transfer cash to Pfizer and retire $1 billion in existing Pfizer debt. Following these transactions, Zoetis had $3.64 billion in long-term debt at the end of June 2013, the most recent figures available, and this compared to $800 million in shareholders' equity.

With organic growth and acquisitions, Zoetis has become a larger company over the last few years. Cash flow from operations in 2011 was almost $500 million, nearly double the 2010 amount, compared to capital expenditures of $135 million. For 2012, operating cash flow declined to $454 million from $497 million in 2011 due to the seasonal inventory building for cattle products and higher inventory levels of other targeted products. Capital expenditures of $126 million in 2012 were relatively modest in relation to cash flow. We look for higher cash flow in 2013. Zoetis pays a modest quarterly dividend of $0.065 per share.

Estimates

With the strong third quarter revenue, ZTS management narrowed its 2013 revenue guidance range to $4.475 billion to $4.525 billion from of $4.425 billion to $4.525 billion previously. Our 2013 revenue projection calls for continued single-digit U.S. revenue growth, assuming more normal weather patterns versus the 2012 drought. Some moderation in feed costs could occur as corn stocks were higher than expected and record corn planting is expected this year. European sales could benefit from positive currency in the euro versus the dollar, though some economic problems could persist. New product launches could add to sales. Growth in emerging markets is expected to continue. In all, we look for 2013 revenue of $4.50 billion, up 4% from $4.34 billion in 2012. We expect margin improvement due to acquisition integration and synergies from acquisitions in recent years. We forecast a modest decline in the gross margin for the year due to product and geographic mix effects, partially offset by operational efficiencies and gains from acquisition integration. Despite the faster growth in the third quarter, we look for a small increase in SG&A despite costs to operate as a standalone company. R&D could also decline modestly. We incorporate a high level of interest expense resulting from the separation and a lower tax rate in our projection. Management also narrowed its 2013 EPS guidance range to $1.38 to $1.42 from $1.36 to $1.42 previously, excluding non-recurring items. Our 2013 EPS estimate is $1.40.

Outlook

As a global provider of animal health products, Zoetis has numerous potential avenues to sustain revenue and earnings growth. With the company’s large direct sales force, established customer relationships could result in market share gains and could facilitate the adoption of new products.

Along the same lines, Zoetis spends sizeable amounts on R&D and has been responsible for a significant percentage of new products within its industry. Continued new product development and introduction can enhance the existing product line and provide additional medicines and vaccines to be marketed by ZTS’s sales force. Finally, the company’s worldwide marketing capabilities could make Zoetis an attractive partner for licensing of new products and technologies.

Emerging markets are a potential source of revenue growth as standards of living improve and the demand for animal protein grows. Similar factors can spur additional spending on companion animals. The Asia/Pacific region has been growing in local currencies, though exchange has been unfavorable. Canada and Latin America have performed well, though currency has been negative, as well.

We look for ZTS to pursue complementary acquisitions. The addition of businesses acquired as part of acquisitions by Pfizer, including Fort Dodge Animal Health (Wyeth) and King Animal Health (King Pharmaceuticals) boosted growth in 2010 and 2011, respectively. Smaller tuck-in acquisitions could add products, technology, or an expanded sales presence.

Conclusion

There are no large, publicly traded animal health companies similar to Zoetis to use as a benchmark valuation for Zoetis. Other such businesses are generally part of multinational pharmaceutical firms, similar to the case of Pfizer's previous ownership of Zoetis. As a standalone business, we have noted certain attractive characteristics of Zoetis. Revenue is fairly reliable due to the needs of livestock producers and pet owners. In addition, research is generally faster and less expensive because clinical studies are less expensive than for human pharmaceuticals. The business is typically self-pay as opposed to third party reimbursement in health care. Finally, there tends to be less generic competition and more brand loyalty. From a financial standpoint, we feel gross margins of over 60% and operating margins of about 25% are relatively high though below that of drug companies.

Zoetis is rated Buy. We view Zoetis as a large capitalization growth stock with a strong market position and attractive growth prospects. As a proxy for valuing Zoetis, we looked at a group of companies deriving some or all of their business from the manufacture or distribution of animal care products. After reviewing the comparative valuations, the average P/E ratio is about 23 times. We feel Zoetis might receive a premium due to its size, global reach, and strong market position. With the ZTS shares currently trading at 23 times our 2013 EPS estimate, we feel the stock is attractive. Our price target is $36 per share. We arrive at our target by using our 2014 EPS estimate of $1.60 and assuming ZTS could at least maintain or possibly improve on its current valuation.

Risks and Considerations

Risks to our valuation include but are not limited to:

Restriction on use of animal medicines. Resistance to using anti-bacterials or other medicines in animals used for food could reduce demand and negatively impact revenue.

Conditions in the livestock industry. Unfavorable economics in the cattle, poultry, or swine markets could result in smaller herds and reduced demand for animal care products.

Weather extremes. Drought conditions can raise the cost of animal feed, leading to reductions in herd size.

Acquisition-related integration risks. Zoetis has augmented organic growth with acquisitions. Merging of different corporate cultures could make it difficult to achieve desired synergies.

Failure of new products. Zoetis spends a considerable amount on R&D to develop new products. Failure of products to achieve the desired result or reach the market could negatively affect revenue and earnings.

Economic activity. Rising standards of living, particularly in emerging markets, has increased the demand for animal protein. A weakening of the global economy could reduce this demand. Economic conditions can also affect the amounts consumers can spend on companion animals.

Operating as a separate entity. There will be additional expenses to operate as a standalone company. Pfizer plans to provide support initially, but Zoetis will ultimately be responsible for corporate functions.

High level of debt. Following the separation from Pfizer, Zoetis has $3.64 billion in debt compared to $684 million in equity, along with a significant amount of interest expense.

Prices of stocks mentioned: Pfizer (PFE - $31.26)
Additional information is available upon request

Analyst Certification

I, Stephen A. O'Neil, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

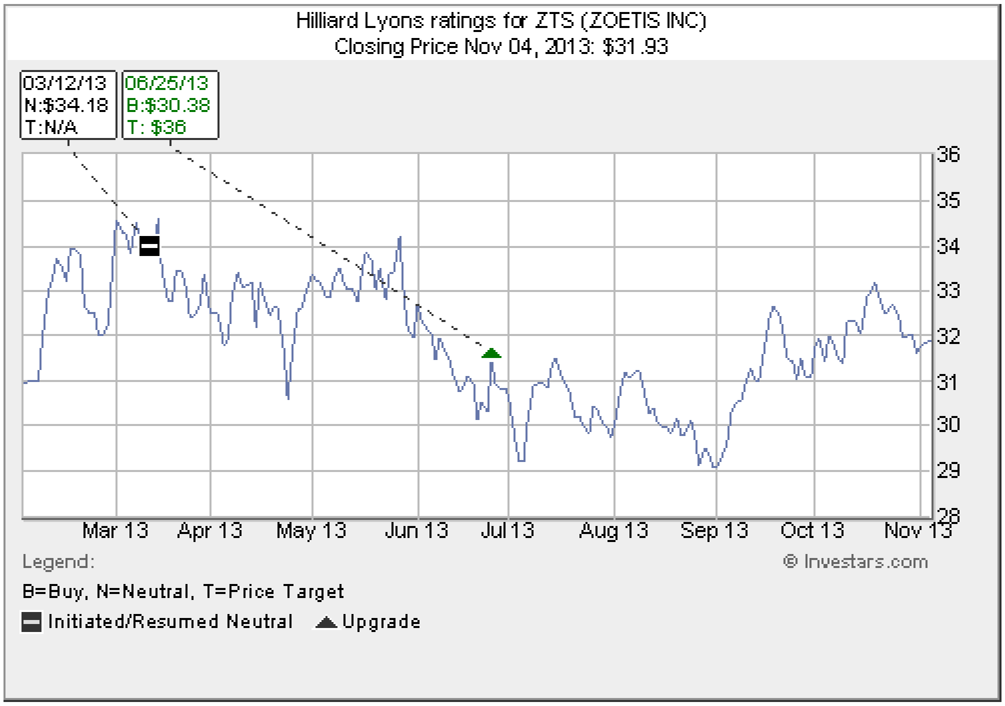
The author of this report or members of his household have a long position in the common stock of Pfizer, but may not engage in buying or selling contrary to the recommendation.

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	53	37%	21%	79%
Hold/Neutral	81	57%	12%	88%
Sell	9	6%	0%	100%

As of 7 October 2013

Other Disclosures

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