

Zoetis Inc.

ZTS - BUY - Industry Trends Underscore the Companion Animal Opportunity for ZTS

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FLASH NOTE

SECTOR: Specialty Pharmaceuticals

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Yesterday evening, Aratana (PETX, NC \$10.25), a development stage companion animal health company, hosted a presentation that we believe underscored the Companion Animal drug opportunity for Zoetis (ZTS, BUY, \$31.33). In 2Q13, 60% of ZTS' sales were from livestock and 40% were from companion animals. Although livestock is still a larger percentage of ZTS's sales, Companion Animal drugs have a higher gross margin. We highlight the key takeaways that support our positive investment thesis on ZTS below. With respect to our overall view on ZTS, we continue to believe that the sustainability of its earnings growth is still underappreciated. Macro trends support the need for ZTS (population, limited resources, Emerging Markets). We expect ZTS's operating leverage to be a driver of EPS growth. In our view, GM improvement will come from price increase and manufacturing savings. SG&A leverage should come from volume increases and moving products in network.

- Significant unmet needs still exist in Companion Animal health. This includes areas such as, pain, anemia, allergy, skin disorders, chronic diseases for aging pets and oncology, among others. Interestingly, Aratana and other animal health companies also see an opportunity to improve upon the safety of currently approved drugs.
- In the U.S., Aratana has seen improving review times for Companion Animal drugs and a more streamlined process at the CVM (Center for Veterinary Medicine). In the EU, the review process is more complex, but Aratana sees ways of improving review times/processes here as well. Currently, the EU approval time is about 9 to 12 months slower than the U.S.
- Animal drugs have a higher probability than human drugs of getting approved since much of the drug development process is de-risked upfront and the CVM does not usually change the endpoints.
- Animal drug development takes about half the time of human drug development for two key reasons, (1) proof of concept can be established in the target animal and, (2) only one pivotal study is required.
- Interestingly, CMC (Chemistry, Manufacturing and Controls), is often the hardest and sometimes rate limiting step in the Companion Animal drug approval process.
- Although, it was not discussed at the Aratana presentation, other animal health companies that we have spoken with have become increasingly interested in Companion Animal diagnostics. The reason is that these usually need to be done by the veterinarian. This offsets the increasing number of pet meds which are being filled at the retailer, which has decreased veterinary sales of these drugs.

Potential Stock Moving Catalysts. 1) Operating margin expansion; 2) new product launches; 3) business development; 4) expansion into adjacent categories; 5) U.S. drought subsidies; and 6) strong flea and tick season.

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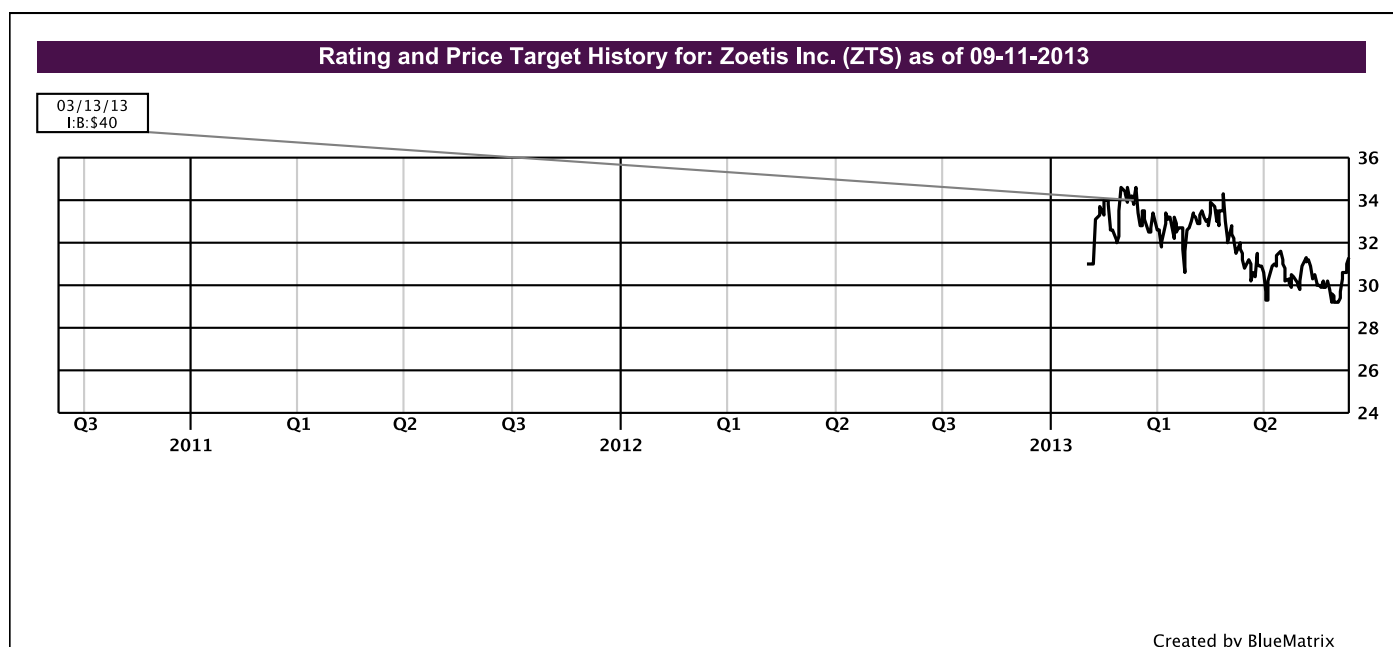
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