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Stock Rating
Equal-weight

Industry View
In-Line

Initiation

Zoetis Inc.

Fundamentals warrant high P/E; awaiting EPS upside

Initiating coverage with an EW rating. ZTS is a global leader in animal health, and we expect mgmt. to deliver mid-teens EPS growth over the next several years. However, ZTS shares are up 30% (vs. S&P +4%) since IPO on Feb. 1, and we see a balanced risk reward at 24x our 2013E EPS.

ZTS is a compelling alternative to traditional pharma. Zoetis is a leader in the attractive, $22B animal health market. Relative to traditional pharma, ZTS has a more diversified revenue base, faces no major patent cliffs, and offers higher terminal growth prospects.

Strong, experienced management team should deliver. We forecast mid-teens annual EPS growth in '13-'15E driven by mid-single digit revenue growth and operating margin expansion. We believe a 28% O.M. is attainable by '15E or earlier (vs. 22% in 2012E) in light of leading global pharma companies with a 40% O.M. and leading global pure play generics with a 20-30% O.M.

But valuation reflects a balanced risk-reward, in our view. At 24x our 2013E EPS of $1.41 (20x 2014E EPS) and 16x our '13E EBITDA (14x 2014E EBITDA), ZTS trades at a premium to Large-Cap Growth companies like Monsanto, Mead Johnson, and Perrigo as well as SMID-Cap Animal Health companies like Idexx, VCA, and Virbac. Given ZTS's premium multiple on EPS and EBITDA, we think material EPS upside is required to drive stock outperformance.

Investor concerns are headline risks rather than financial risks. We believe only 3% of global revs are at risk to new U.S. regulations that seek to limit the use of antibiotics for growth promotion. In addition, we believe the risk of large pharmacy chains entering animal health and pressuring Zoetis' margins is modest and long-term in nature. This is because the majority of companion animal scripts are for injectables or acute uses, where the convenience of vet office dispensing trumps potential costs savings from off-site pharmacies. **See detailed investment debates on pages 19-28.**

Key Ratios and Statistics

Reuters: ZTS.N Bloomberg: ZTS US
Specialty Pharmaceuticals / United States of America

Shr price, close (Mar 11, 2013)	$34.18
Mkt cap, curr (mm)	$17,090
52-Week Range	$34.89-30.50

Fiscal Year ending	**12/12e**	**12/13e**	**12/14e**	**12/15e**
Revenue, net ($mm)	4,351	4,544	4,882	5,164
EBITDA ($mm)**	1,124	1,242	1,419	1,573
ModelWare EPS ($)	**1.25**	**1.41**	**1.65**	**1.87**
P/E	**27.4**	**24.3**	**20.7**	**18.3**
Consensus EPS ($)§	**1.41**	**1.46**	**1.62**	**1.78**
Div yld (%)	0.0	0.8	0.9	1.0

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).
§ = Consensus data is provided by Thomson Reuters Estimates.
****** = Based on consensus methodology
e = Morgan Stanley Research estimates

Quarterly ModelWare EPS

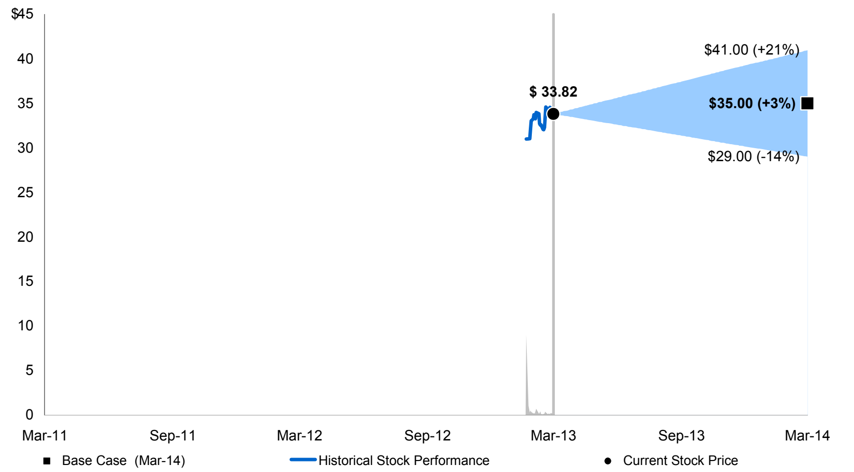
Quarter	**2011**	**2012e Prior**	**2012e Current**	**2013e Prior**	**2013e Current**
Q1	0.24	-	0.30a	-	0.33
Q2	0.23	-	0.35a	-	0.37
Q3	0.29	-	0.31a	-	0.35
Q4	0.24	-	0.28	-	0.36

e = Morgan Stanley Research estimates, **a** = Actual company reported data

Contents

Risk- Reward Snapshot: Zoetis Inc. (ZTS, Equal-weight)

We see a balanced risk-reward; earnings upside will dictate potential stock outperformance



Source: Thomson Reuters, Morgan Stanley Research estimates

Price Target N/A		Valuation based upon 2014E P/E and EV/EBITDA
Bull Case $41	22x Bull Case 14e EPS of $1.87	**Significant earnings upside drives stock outperformance.** Our bull case assumes Zoetis can earn in 2014E what we project for 2015E (EBITDA of $1.57B and EPS of $1.87). Faster-than- expected realization of margin expansion (bull case '14E O.M. of 27.5% vs. base case '14E O.M. of 25.8%) is a key driver of EPS upside.
Base Case $35	21x Base Case 14e EPS of $1.65	**We see Zoetis shares as fairly valued on 2014E P/E and EV/ EBITDA.** ZTS currently trades in-line with the highest multiple Large Cap Growth and SMID-cap Animal Health companies in our comparables universe. Given ZTS' premium multiple on EPS and EBITDA, we believe earnings upside is necessary for stock outperformance. Our base case assumes 4% YOY rev. growth in '13E accelerating to 7% in '14E on easier drought-related comps (we est. the drought is a 2% headwind in '13E).
Bear Case $29	19x Bear Case 14e EPS of $1.53	**Bear case assumes margin expansion fails to materialize.** Our bear case assumes 2014E EBITDA margins in-line with our 2013E est. of 27.3%. Scarcity value could diminish if free float expands.

Exhibit 1

ZTS trades at a premium to Large Cap Growth Companies on 2013E/ 2014E EPS and EBITDA

	MON	SYT	AGN	MJN	PRGO	NOVO	Mean	ZTS
'13E P/E	22.6x	16.8x	23.1x	21.7x	20.9x	21.6x	21.1x	24.1x
'13E EV/EBITDA	12.3x	11.6x	14.5x	14.5x	13.4x	15.4x	13.6x	16.3x
'14E P/E	20.0x	13.2x	20.2x	19.2x	17.9x	19.4x	18.3x	20.4x
'14E EV/EBITDA	11.1x	10.4x	12.8x	13.0x	11.8x	13.9x	12.2x	14.3x

Ticker legend: MON Monsanto, SYT Syngenta, AGN Allergan, MJN Mead Johnson, PRGO Perrigo, NOVO Novo Nordisk
Source: Thomson Reuters, Morgan Stanley Research

Investment Thesis

- Zoetis is a global leader in animal health, and we expect mgmt. to deliver mid-teens EPS growth over the next several years.
- We believe current valuation (24x '13E EPS and 16x '13E EV/EBITDA) reflects a balanced risk-reward
- We view ZTS as a compelling alternative to traditional pharma
- But given ZTS's premium multiple on EPS and EBITDA, we think material earnings upside is required to drive stock outperformance

Key Value Drivers

- Operating margin expansion (we project 200 b.p. annual improvement over the next two-three years)
- Livestock (65% of revs.): Demand for meat and milk is projected to at least double over the next 40 years due in large part to population growth and an increase in affluence in emerging markets (key driver of NT growth)
- Companion Animals (35% of revs): Global spending on pets is growing

Potential Catalysts/ Launches

- Quarterly financials and 2013 guidance (late April when PFE reports 1Q:13 earnings)
- U.S. drought developments (we expect conditions to improve in 2H:13)
- Implementation of new antibiotic restrictions and potential for new govt. legislation
- Vet Rx legislation

Investment Risks

- Margin expansion fails to materialize
- Drought persists longer than expected
- Increased govt. antibiotic regulations
- New pharmacy entrants pressure ZTS margins
- SAP implementation

Investment Case

Summary and Conclusions

Initiating coverage with an Equal-weight rating
Zoetis is a leader in the attractive, $22B animal health market, and we expect management to deliver mid-teens earnings growth over the next several years. However, Zoetis shares are up 30% (vs. S&P +4%) since IPO at $26 on Feb. 1, and we believe current valuation (24x our 2013E EPS and 16x EV/EBITDA) reflects a balanced risk-reward. We calculate a $20.3B EV as follows: $17B equity value (501.5M fully diluted shares * current share price) + $3.3B net debt (total debt of $3.65B minus cash of $330M). See charts on page 16.

Zoetis is a compelling alternative to traditional pharma.
Relative to traditional human health pharmaceutical companies, Zoetis has a more diversified revenue base, faces no material patent cliffs, and has greater growth prospects in both established and emerging markets.

Generic threats are limited
Generic competitors face several challenges (limited product portfolios, difficulty making inroads with veterinarians and livestock producers), and some notable companies (including Teva and Ranbaxy) have exited. Furthermore, Putney (privately held generic animal health company) has struggled to make inroads with U.S. vets according to our consultants, and Perrigo is focused on the OTC (e.g., flea/tick) side of the market.

Strong, experienced management team should deliver.
CEO Juan Ramon Alaix is well-respected in the industry and has consistently delivered organic revenue growth even in the wake of the 2009 recession in which the global animal health market declined by 3%. CFO Rick Passov is the former Treasurer of Pfizer and played key roles in the Pharmacia and Wyeth acquisitions. Finally, country unit heads each have several years of animal health experience, both as business managers and veterinarian practitioners.

But current valuation appears to reflect a balanced risk-reward.
At 24.1x our 2013E EPS of $1.41 and 20.4x our 2014E EPS of $1.65, Zoetis trades at a significant premium to the Large-Cap Growth and SMID-Cap Animal Health companies that we have selected for our comparables universe. While valuation is a challenge given no public large-cap animal health peer, we do not foresee catalysts that would drive significant near-term multiple expansion.

Given premium valuation on EPS and EBITDA, we believe material earnings upside is required to drive stock outperformance

3 potential sources of upside:

Projections too conservative given drought concerns: 4Q animal health growth reported by Pfizer (+8% YOY constant currency) suggests management is executing better than expected in the wake of current U.S. drought. Our model currently assumes a 2% revenue hit from the drought in 2013E, which may prove overly conservative in light of 4Q top-line performance.

Greater-than-expect margin expansion: Our model assumes 200 b.p. of annual operating margin expansion over the next in 2013-15E, but some bulls see greater upside given Sanofi/ Merial's 31% operating margin (vs. Zoetis' 2012E OM of 22%). While Merial has more exposure to the higher-margin companion animal segment, bulls argue that Zoetis may be over-investing in SG&A and R&D relative to Merial.

Bolt-on M&A: We project $2.4B of cumulative operating cash flow in 2013-2015E. While mega mergers in animal health may be unlikely (recall authorities blocked a combination of Merck and Sanofi's animal health units in 2011), we expect Zoetis to pursue bolt-on M&A in adjacent categories, including diagnostics, branded generics, and poultry. *Our model assumes no contribution from unannounced M&A*.

Investment concerns mainly pose headline risks and are unlikely to impede financial performance
Some investors are concerned about potential increased U.S. regulations on the use of antibiotics in food- producing animals, and the risk of companion animal channel shift from vet pharmacies to large retail/ online chains. We believe approximately 3% of global revenues are at risk to increased antibiotics regulations (see quantification on p. 25). In addition, recently proposed legislation seeking enhanced disclosure of antibiotics usage is much less ambitious than previous failed attempts to ban non-therapeutic uses of antibiotics (e.g., for growth promotion). In terms of companion animal channel shift, we think the risk that large pharmacy chains could pressure Zoetis' margins is low. This is because a majority of companion animal health prescriptions are injectables or for acute uses, where the convenience of on-site dispensing trumps potential cost savings from off-site pharmacies.

Key Investment Debates Summary (see details on pp. 19-28)

Debate	Bull/ Bear	Market View/ Our View
1) What is Zoetis' operating margin expansion potential?	**Bull Case** Bulls point to Zoetis' 29 manufacturing sites, 200 contract manufacturers and further potential synergies from the Wyeth Fort Dodge and King Animal Health acquisitions as sources of greater-than- expected margin upside. Bulls also point to Sanofi/ Merial's 31% O.M. (vs. ZTS' 2012E OM of 22%) as a benchmark for future upside. **Bear Case** Zoetis' adjusted operating margins have expanded 1000 b.p. from 11.6% in 2009A to 21.9% in 2012E and may only trend up marginally higher from current levels. In addition, the loss of Pfizer's buying power, incremental stand-alone/ public company costs, and a 15% markup on Pfizer-supplied products after 2014 could be underappreciated headwinds.	**Market View** Investors are generally bullish on Zoetis' margin outlook, but look forward to greater clarity from management on specific cost savings and/ or efficiency opportunities. **Our View** We project 200 b.p. of annual operating margin expansion in 2013-2015E as Zoetis' realizes operating leverage from list price increases, greater capacity utilization, sales force productivity, and prudent R&D expense management.
2) What is the risk of increased government regulations on livestock antibiotics?	**Bull Case** Regulations are unlikely to impede financial performance because FDA guidance is voluntary and affects a small portion of Zoetis' global revenues. **Bear Case** Global regulations on additional uses of antibiotics, including disease prevention, could threaten up to 30% of total company revenues.	**Market View** Investors believe increased regulations are mainly a headline risk, but struggle to quantify ZTS' theoretical revenue exposure. **Our View** We believe only 3% of global revenues are at risk to increased U.S. govt. regulations on the use of antibiotics. In addition, recently proposed U.S. legislation seeking enhanced disclosure of antibiotics usage is less ambitious than previous failed attempts to ban non-therapeutic uses (e.g., for growth promotion). We will continue to watch developments in Europe and Asia.
3) Will new pharmacy entrants and Vet Rx legislation drive increased price pressure and generic substitution?	**Bull Case** Pet owners continue to purchase the vast majority of companion animal prescriptions from veterinary pharmacies, which have less pricing power than big box retailers or major pharmacy chains **Bear Case** H.R. 1406 (Fairness to Pet Owners Act) is revived, and results in pet owners having Vet Rx's filled at their local pharmacies. These pharmacies push increased generic substitution and other lower-cost alternatives which ultimately squeeze Zoetis' sales and margins. Perrigo makes inroads in OTC (non-prescription) products.	**Market View** Investors question whether the shift from vet office to online/ big box retailers and proposed Vet Rx legislation requiring mandatory written prescriptions will drive increased generic substitution and pressure companion animal Rx margins. **Our View** Dog and cat owners are no longer held captive to in-house vet pharmacies, but the vast majority of scripts are still filled in vet offices. Perrigo's niche efforts are focused on OTC flea and tick, which poses a limited risk to Zoetis. Even if HR 1406 is ultimately passed, we believe the risk is low because the majority of companion animal Rx's are injectables and/or for acute uses.

Company and Industry Overview

Zoetis is the former animal health unit of Pfizer
Pfizer sold 99M Zoetis shares in an Initial Public Offering on February 1, 2013. Pfizer maintains 80.2% ownership in Zoetis and plans to divest its remaining share (via a spin-off or equity exchange) at a later date. Zoetis participates in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on livestock and companion animals.

Zoetis is a global animal health company specializing in livestock and companion animals
Zoetis sells over 300 product lines in 120 countries. The company's portfolio includes vaccines, parasiticides, anti-infectives, and medical feed additives. Approximately 65% of the company's revenues come from livestock pharma/vaccines, and 35% come from companion animals. Zoetis' livestock products enable the cost effective production of safe, high-quality animal protein. Core species include cattle (beef and dairy), swine, poultry, sheep, and fish. Zoetis' companion animal products extend and improve quality of life and increase convenience/ compliance for pet owners. Core species include dogs, cats, and horses.

Exhibit 2
Zoetis is the global market leader in Animal Health

Global Animal Health ($22B)		
Rank	Company	Share
1	**Zoetis**	**19%**
2	Merck	15%
3	Merial (Sanofi)	13%
4	Elanco (Lilly)	8%
5	Bayer	7%
6	Boehringer	6%
7	Novartis	5%
8	Virbac (public)	4%
9	Ceva (private)	3%
10	Vetoquinol (public)	2%
	Other	19%

Notes: 2011 sales compiled by Vetnosis exclude non-Animal Health products and are pro forma for acquisitions/ divestitures as of 12/31/11
Source: Vetnosis, Morgan Stanley Research

Exhibit 3
Zoetis has market leading positions across various species and product categories

Livestock ($13.1B)			Companion Animal, Other ($8.9B)		
Rank	Company	Share	Rank	Company	Share
1	**Zoetis**	**20%**	1	Merial (Sanofi)	20%
2	Merck	18%	**2**	**Zoetis**	**16%**
3	Elanco (Lilly)	11%	3	Bayer	11%
4	Merial (Sanofi)	8%	4	Merck	9%
5	Boehringer	7%	5	Novartis	8%

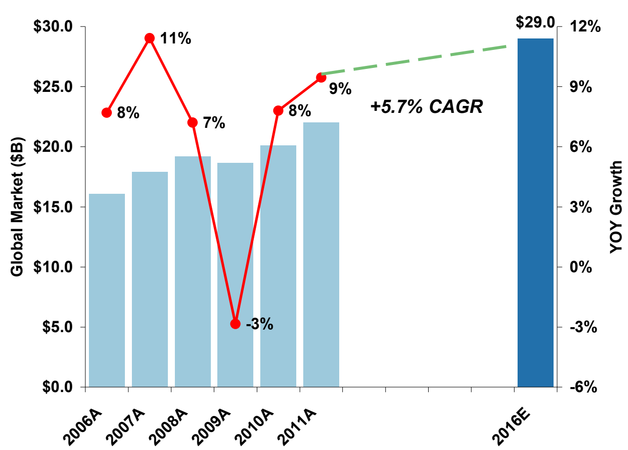
Cattle ($5.5B)			Pigs ($4.0B)			Poultry ($2.5B)			Sheep ($1.1B)		
Rank	Company	Share	Rank	Company	Share	Rank	Company	Share	Rank	Company	Share
1	**Zoetis**	**26%**	**1**	**Zoetis**	**17%**	1	Merck	23%	1	Merck	12%
2	Merck	21%	2	Boehringer	15%	**2**	**Zoetis**	**18%**	2	Novartis	11%
3	Elanco (Lilly)	12%	3	Merck	13%	3	Elanco (Lilly)	15%	3	Merial (Sanofi)	6%
4	Merial (Sanofi)	8%	4	Elanco (Lilly)	9%	4	Merial (Sanofi)	15%	4	Ceva (private)	5%
5	Bayer	6%	5	Novartis	5%	5	Ceva (private)	9%	**5**	**Zoetis**	**5%**

Parasiticides ($6.3B)			Biologics/ Vaccines ($5.7B)			Anti-Infectives ($3.2B)			Medical Feed Additives ($2.6B)			Other Pharma ($4.3B)		
Rank	Company	Share	Rank	Company	Share	Rank	Company	Share	Rank	Company	Share	Rank	Company	Share
1	Merial (Sanofi)	26%	1	Merck	28%	**1**	**Zoetis**	**42%**	1	Elanco (Lilly)	39%	**1**	**Zoetis**	**17%**
2	Bayer	17%	**2**	**Zoetis**	**18%**	2	Merck	17%	**2**	**Zoetis**	**14%**	2	Merck	11%
3	**Zoetis**	**10%**	3	Merial (Sanofi)	16%	3	Bayer	8%	3	Merck	9%	3	Boehringer	8%
4	Novartis	10%	4	Boehringer	15%	4	Vetoquinol (public)	5%	4	Novartis	7%	4	Virbac (public)	7.3%
5	Merck	6%	5	Ceva (private)	4%	5	Virbac (public)	5%	5	Ceva (private)	1%	5	Elanco (Lilly)	6.9%

Notes: 2011 sales compiled by Vetnosis exclude non-Animal Health products and are pro forma for acquisitions/ divestitures as of 12/31/11
Source: Vetnosis, Morgan Stanley Research

Zoetis maintains market leadership positions across many countries, species, and product categories
According to market data from Vetnosis, a research and consulting firm specializing in animal health and veterinary medicine, Zoetis is the number one global animal health company with 19% share. Globally, Zoetis is trailed by Merck (15% share), Sanofi's Merial (13% share), and Lilly's Elanco (8% share). Zoetis is number one in livestock and number two in companion animals behind Sanofi's Merial, which sells the blockbuster flea/tick medicine, FrontLine (annual sales of approx. $1B prior to patent expiry in 2011). Among specific product categories, Zoetis is #1 in anti- infectives, #2 in biologics/vaccines and medicinal feed additives, and #3 in parasiticides.

Exhibit 4
Vetnosis projects 5.7% global market CAGR in 2011-2016E



Source: Vetnosis, Morgan Stanley Research

Animal Health pharmaceuticals and vaccines are a growing $22B+ global market.
According to Vetnosis, global animal health pharma/ vaccines grew at a 6% CAGR between 2006 and 2011 (2009 was the only down year on account of the global recession). Vetnosis projects 5.7% industry CAGR in 2011-2016E. Total market growth in Zoetis' Canada/ Latin America (CLAR) and Asia Pacific regions (+7.9% and +7.5%, respectively) is expected to outpace the U.S. and Europe, Africa, Middle East (EuAfME) (+4.5% and +4.4%, respectively) according to Vetnosis. We project 6% revenue CAGR, including 2% from volume, 2% from price, and 2% from innovation.

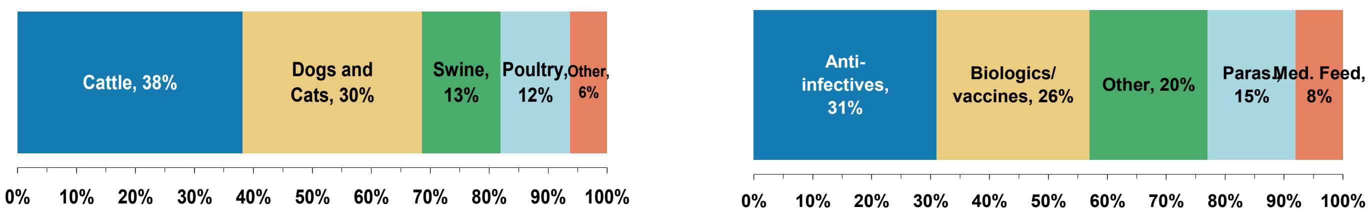
Emerging markets and increased spending on pets should support sustainable long-term growth
In livestock, demand for meat and milk is projected to at least double over the next 40 years due in large part to population growth and an increase in affluence in emerging markets. Emerging markets are key drivers of increased demand for high quality animal protein. With increased scarcity of cultivated land (25-35% of arable land is already degraded), farmers are expected to place a premium on animal health products that drive productivity gains.

In companion animals, per capita consumption is increasing as pets are living longer and becoming more integrated into owner households. For example, 44% of U.S. dogs were over 6 years old in 2008 vs. 32% in 1987. In 2010, 78% of U.S. companion animals were medicated vs. 57% in 1996. Emerging markets are also driving growth in companion animal health sales. According to Euromonitor (June 2012), total spending on pets in Latin America grew at a 13.9% CAGR in 2007-2012 compared to 3.8% CAGR in the U.S. over the same period.

Zoetis' portfolio is highly diversified
No single product accounted for more than 8% of 2011A revenues (Excede, a single-dose antibiotic for the treatment and control of bovine respiratory disease and foot rot in cattle). No single country (U.S.), species (cattle), or product categories (anti-infectives) accounted for more than 40% of 2011A revenues. Zoetis' top ten products accounted for 38% of 2011A revenues (vs. >60% for U.S. major human pharmaceutical companies).

Zoetis has the largest direct sales force in animal health; strong customer relationships enable price leverage
Zoetis has 3,400 sales representatives in 70 countries. This direct selling model has allowed Zoetis to cultivate stronger relationships with key decision makers relative to many of its peers, which primarily rely on third-party distributors. By offering on-farm/ in-clinic technical support and economic outcomes research, management hopes that veterinarians and livestock producers come to view Zoetis sales reps as trusted advisors. According to company-commissioned market research, Zoetis' field force is viewed as #1 in most major geographies.

Exhibit 5
Zoetis is highly diversified across species and product categories (based upon 2011A revenues)



Notes: Other products include pain and sedation and other non-pharma (e.g., services, diagnostics); Paras. is an abbreviation for Parasiticides; Other species include fish, sheep, and horses
Source: Company data, Morgan Stanley Research

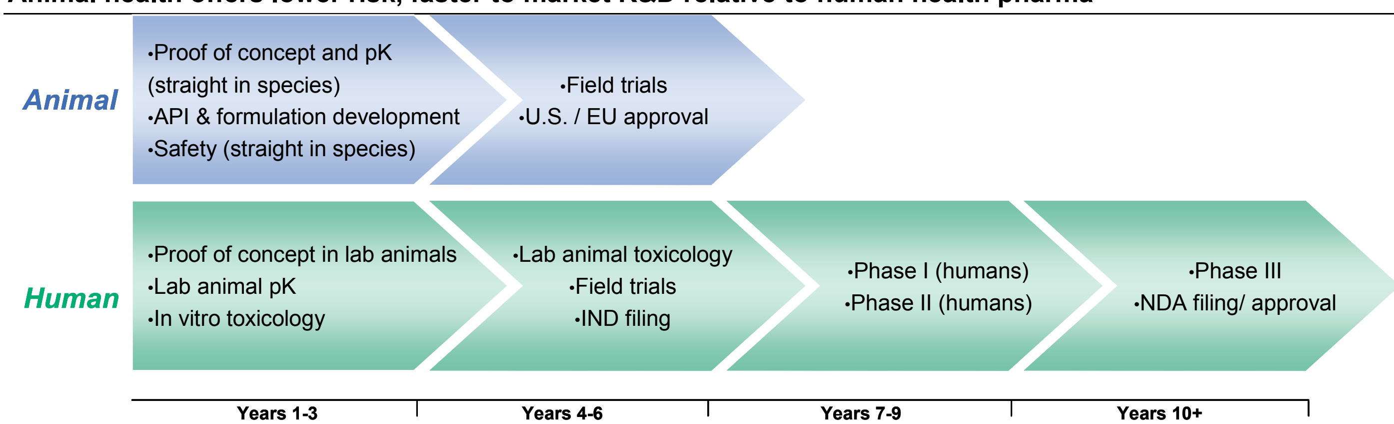
Zoetis spends 8-9% of annual revenues in R&D.
The majority of annual investment is spent on brand cycle development (e.g., new species, combinations, reformulations) vs. new products (e.g., new chemical/ biological entities). From 2004-2011, Zoetis received approximately 25% of all animal health medicine approvals granted by the FDA and approximately 20% of all animal health vaccine approvals granted by the USDA.

Zoetis has access to Pfizer's compound library through 2020, but R&D has functioned independently of Pfizer since 2003.
Under the terms of the separation agreement, Zoetis has continued access to Pfizer's proprietary compound library through 2020. However, this access should not be misconstrued as dependence, as there is limited overlap with Pfizer R&D (Zoetis is focused on parasiticides, vaccines, and productivity products). According to our channel checks, Zoetis has not benefitted significantly from Pfizer's human health R&D expertise over the last several years.

Zoetis has positioned itself as the partner of choice for new products.
Business development has been a key corporate function for over 10 years, and management actively pursues licensing/ collaboration agreements for new technologies and substrates. In fact, Zoetis' current pipeline is enabled by over 150 global collaborations.

Unmet medical needs uncovered by our channel checks.
Bacteria evolve and resistance to current therapies is a risk. In livestock, our experts underscored antibacterials that increase efficiency of livestock animals. In companion animals, our experts highlighted atopic dermatitis (itchy skin), oral health (halitosis), arthritis, and pain control in cats as underappreciated opportunities.

Exhibit 6
Animal health offers lower risk, faster to market R&D relative to human health pharma



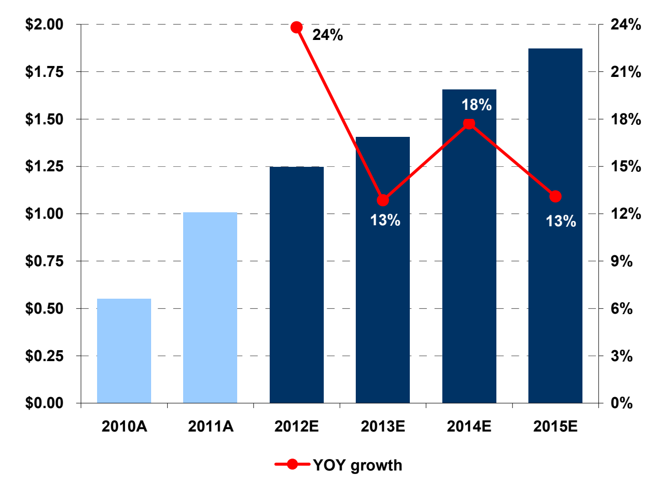
Source: Company Data, Morgan Stanley Research

Financial Overview

High-level financials

We project 14% EPS growth in 2013-2015E.
Our '13-'15E revs. / EPS are: $4.5B/$1.41, $4.9B/ $1.65, and $5.2B/ $1.87. We forecast mid-teens annual EPS growth in 2013-15E driven by mid-single digit top line growth (we project 6% revenue CAGR in '13-'15E) and significant operating leverage (we project 200 b.p. of annual operating margin expansion). We expect top-line growth in emerging markets like Asia Pacific (+9% CAGR in '13-'15E) and Canada/ Latin America (+8% CAGR in '13-'15E) to outpace growth in the more established U.S. (+5% CAGR) and EuAfME (+4% CAGR) markets. In terms of operating margin expansion, we expect roughly 40% of our 200 b.p. projection to come from gross margin improvement (e.g., greater capacity utilization, list price increases) and 60% from R&D and SG&A.

Exhibit 7
We project mid-teens EPS growth in 2013-2015E driven by mid-single digit revenue growth and 200 b.p. of annual operating margin expansion



Source: Company Data, Morgan Stanley Research estimates

Drought impact

We estimate that the drought will cause a 1-2% ($45-$90M) top-line headwind in 2013E (majority in 1H:13E), setting the stage for easier comps in 1H:14E
The current drought in the western hemisphere is the worst in over 100 years, and it is negatively impacting livestock animal health products. U.S. cattle (est. 14% of global revenues) are the primary species affected due to the reduced availability of grazing pasture and supply of corn on feedlots. U.S. poultry and hogs are being impacted to a lesser extent. In Latin America, the drought is primarily affecting cattle production in Northern Mexico (Brazil is not significantly impacted). The good news is that the drought is expected to end in 2H: 13, and revenue growth should accelerate in 2014E on the back of easier comps. As a result, we project YOY revenue growth of +4% in 2013E accelerating to +7% in 2014E, and normalizing at +6% in 2015E.

4Q animal health revenues reported by Pfizer suggest management is executing better than expected in the wake of the current drought.
Pfizer reported 8% constant currency YOY growth in Animal Health revenues in 4Q:12A. We had previously expected flat growth in 4Q given a YOY decline in feeder cattle placements (demand for Zoetis products is greatest in feedlots), but Pfizer-reported results suggest Zoetis is executing better than we had expected. Hence, our 2013E drought projections could ultimately prove conservative. Caveat is that Pfizer Animal Health revenues are not exactly comparable to Zoetis; Zoetis sales also include Pfizer CentreSource revenues (Pfizer's contract manufacturing and bulk pharmaceutical sales operations) associated with plants that will be housed within Zoetis. For reference, we estimate 4Q:11A CentreSource revenues were approx. $20M.

One-time charges

One-time costs (related to the Pfizer separation) of $200-$240M in 2013E and $100-$140M in 2014E <u>will be excluded from non-GAAP EPS.</u>
As a standalone public company, Zoetis expects to incur internal costs of $30-$40M in 2013 and 2014 to implement new systems, including enterprise resource planning (ERP). In addition, Zoetis projects one-time costs of $170M-$200M in 2013E and $70-$100M in 2014E related to new branding, the creation of a standalone infrastructure and certain legal registration and patent assignment costs. Total costs of $200-$240M in 2013E and $100-$140M in 2014E are non-recurring and, hence, will be excluded from the calculation of non-GAAP EPS. However, recurring costs of $15-$25M related to the Pfizer separation will <u>not</u> be excluded from non-GAAP EPS. These "dis-"synergies are related to incremental costs that exceed the amounts that were historically allocated by Pfizer under cost accounting.

Tax rate

We project a 29% tax rate in 2013-2015E
This compares to 34% in 2011A and 2012E. As a business unit of Pfizer, Zoetis did not play a major role in Pfizer's tax planning, but as a stand-alone company, mgmt. plans to prudently manage its tax structure. We see the potential for the tax rate to trend below 29% in 2014 and beyond, as Zoetis realizes a greater percentage of revenues from lower-tax jurisdictions ex-U.S.

Share count

We estimate a fully-diluted share count of approx. 502M shares in 2013E.
Following the IPO, there were 500M basic shares outstanding. In addition, 2013 equity grants at the time of the IPO included 795,310 restricted stock units (RSUs) and options to purchase an aggregate of 2,935,302 shares of Class A common stock, with an exercise price equal to the initial public offering share price ($26/share). For purposes of determining Zoetis' fully-diluted share count, stock options are calculated according to the Treasury Stock Method. Based upon Zoetis' current share price, we estimate a fully-diluted share count (including option and RSU dilution) of 501.6M shares.

Share-based compensation

We expect share based compensation to be included in mgmt's calculation of non-GAAP EPS.
Stock-based awards available under the Equity Plan include: stock options with exercise price no less than 100% of the fair market value of ZTS common stock on the date of grant, restricted stock and restricted stock units, performance based awards which may be equity- or cash-based, and other equity or cash-based awards with a total cash cap of $10M per participant per year. No more than 3M shares (1.5M shares subject to options or stock appreciation rights and 1.5M shares subject to other awards) may be granted in any 12-month period. We believe mgmt. may utilize share buybacks to offset the potential dilutive impact of stock based compensation.

Cash flow outlook

We project cumulative operating cash flow of $2.4B and cumulative free cash flow of $1.9B in 2013E-2015E.
We estimate operating cash flow of $628M in 2013E, $835M in 2014E, and $954M in 2015E. 2013E operating cash flow of $680M compares to $144M for the 9-months ended Sep. 30, 2012 and our full-year 2012 estimate of $159M. Note, however, 2012 included a significant investment in working capital (+$400M for the 9-mos. ended Sep. 30) in advance of the Pfizer separation, which we expect to moderate substantially in 2013E-2015E.

Key drivers of free cash flow growth
Growth in free cash flow in 2014-2015E should be supported by strong growth in adjusted earnings (+18% YOY in 2014E and +14% YOY in 2015E) as well as a substantial step-down in one-time cash charges associated with the separation from Pfizer. Net of annual capital expenditures of $170M in 2013E-2014E and $120M in 2015E, we project cumulative free cash flow (excluding interest payments) of $1.9B in 2013-2015E.

One-time cash charges will negatively impact operating cash flow.
Total after-tax costs of $140-$170M in 2013E and $70-$100M in 2014E will negatively impact operating cash flow (mgmt. will not reported adjusted cash flow). However, operating cash flow should accelerate in 2015 and beyond after these one-time costs have been absorbed.

Debt

Zoetis is highly levered, but strong cash flow should support debt pay-down and bolt-on M&A in coming years.
Post-IPO, we estimate Zoetis will have net-debt of $3.35B, including $3.65B of investment grade (Baa2/BBB-) long-term debt and cash of approx. $300M. Total debt of $3.65B is comprised of: $400M of senior notes due Feb. 2016 (U.S. Treasury + 80 b.p.), $750M due 2018 (T+115), $1.35B due 2023 (T+145), and $1.15B due 2043 (T+175). Based upon current Treasury yields, we estimate a weighted average interest cost of 3.2%. The vast majority of cash proceeds from the senior notes offering were transferred to Pfizer. Net of the Pfizer transfer, we project total debt to 2013E EBITDA of 3.0x and net debt-to-EBITDA of 2.7x.

Dividend

We expect management to raise the dividend over time, but we do not foresee a yield above 1%.
Zoetis' quarterly dividend of $0.065/share implies a 0.8% yield at current valuation. We expect management to raise Zoetis' dividend in-line with earnings growth, but we are not expecting a yield above 1%. We think strategic activity (e.g., bolt-on M&A) and deleveraging are more preferred uses of free cash flow than dividend payments.

IPO structure and ownership outlook

100% of IPO proceeds go to Pfizer via a debt- for- equity exchange
Pfizer sold Zoetis shares to the equity underwriters in exchange for Pfizer debt. This debt was subsequently retired and removed from Pfizer's balance sheet.

Pfizer retains 80.2% ownership post-IPO; 180 day lock-up ends in late-July.
Following the IPO, Pfizer holds 401M Class B shares (80.2% of total). The free float of 99M Class A shares represents 19.8% of the total share count. Class A and Class B shares are identical, except with respect to voting and conversion rights. With respect to the election of directors, Class B shareholders (i.e., Pfizer) are entitled to ten votes per share whereas Class A holders (i.e., free float) are entitled to one vote per share. As a result, Pfizer has >95% of combined voting power with respect to the election of directors. For all other matters subject to shareholder vote, both Class A and Class B holders are entitled to one vote per share. In addition, Class B shares held by Pfizer are convertible into one share of Class A common stock at any time (e.g., upon any potential future distribution/ sales of Zoetis ownership).

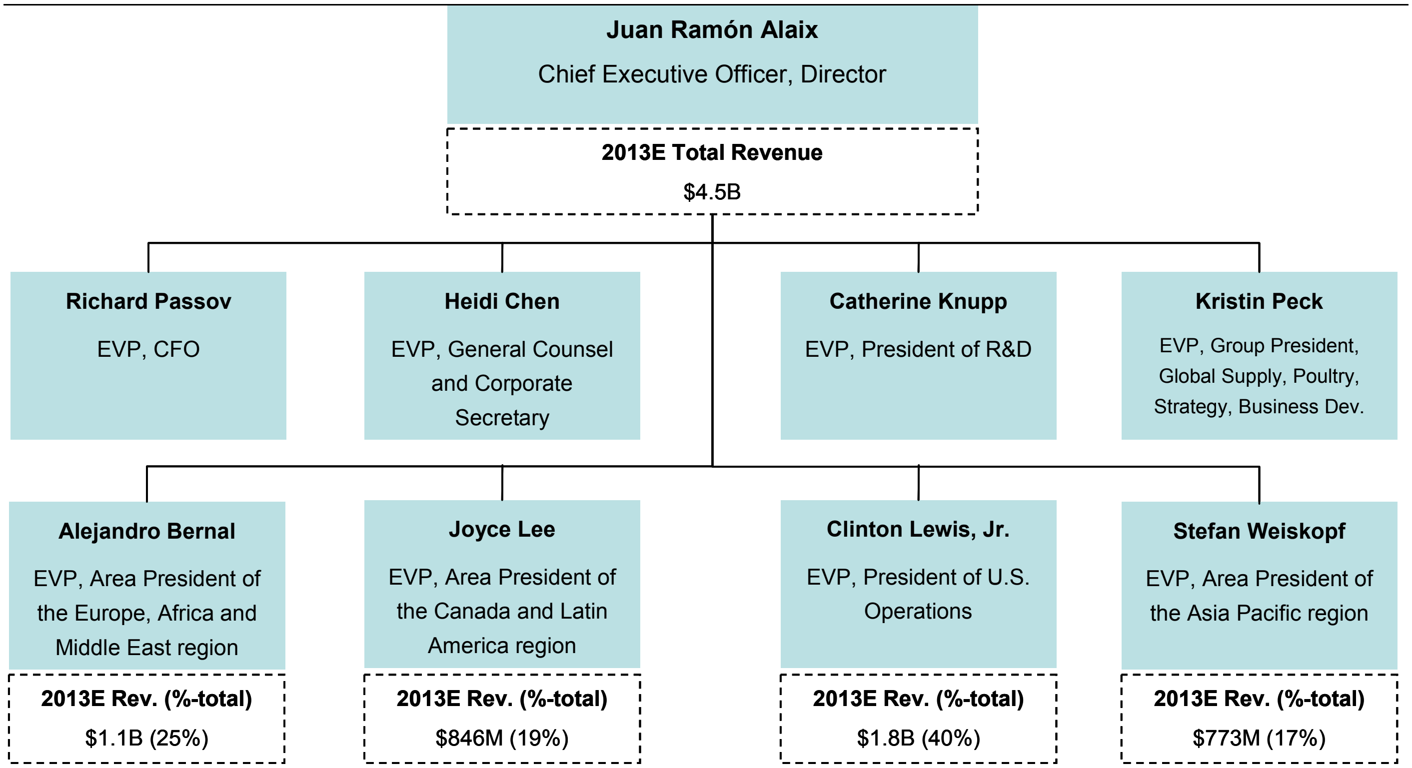
One potential exit scenario?
Given management's intention to further divest its stake, it's worth considering Bristol-Myers Squibb's actions in relation to Mead Johnson. Bristol-Myers sold 17% of Mead Johnson in a $720M IPO in February 2009. In December 2009, Bristol-Myers split off its remaining ownership in a stock-for-stock exchange with BMY shareholders. Under the terms of the split-off, each share of BMY common stock tendered was exchanged for 0.613 shares of Mead Johnson Stock. Because the offer was oversubscribed, Bristol accepted tendered shares on a pro rata basis in proportion to the numbers of shares tendered (~53.9% for shareholders with >100 shares of BMY common stock).

Financial Disclosure

Zoetis discloses revenues by geography, not species.
Reported segments include: U.S., Europe, Africa, Middle East (EuAfME), Canada/ Latin America (CLAR), and Asia Pacific. CLAR and AsiaPac encompass emerging markets (27% of company total), but also include established countries like Canada and Japan. We appreciate how management disaggregates organic growth from FX and acquisitions/ divestitures. But we note that there are currently no plans for quarterly disclosure of revenues by species (e.g., livestock vs. companion animal).

Management and Executive Compensation Overview

Exhibit 8
Organization Structure



Source: Company Data, Morgan Stanley Research

CEO Juan Ramón Alaix is well-respected the industry
Juan Ramón Alaix was named President of Pfizer Animal Health (PAH) in 2006. Alaix has consistently delivered organic revenue growth even in the wake of the 2009 recession in which the global animal health market declined by 3%. In 2009, he successfully transitioned PAH's U.S. go-to-market strategy from a distributor- based to a direct selling model. This direct selling model is relatively unique (competitors primarily rely on third party distributors) and has allowed Zoetis to cultivate stronger relationships with veterinarians and livestock producers who increasingly view their Zoetis' sales reps as trusted advisors. Alaix is also the current president of the International Federation for Animal Health (IFAH). Prior to joining Pfizer in 2003, Alaix held various positions at Pharmacia and Rhône- Poulenc Rorer.

CFO Rick Passov is the former treasurer of Pfizer
Richard Passov was named executive vice president and chief financial officer of Zoetis in July 2012. Prior to joining Zoetis, he served as senior vice president and treasurer of Pfizer since 2001. During his tenure at Pfizer, he played a key role in the $60B acquisition of Pharmacia in 2002, the $17B divestiture of Pfizer's Consumer Healthcare business to J&J in 2006, and the $68B acquisition of Wyeth in 2009.

General Counsel Heidi Chen is a 14-year veteran of Pfizer
Chen has served as Zoetis' General Counsel since October 2012, as Zoetis' Corporate Secretary since July 2012, and as Vice President and Chief Counsel of Pfizer Animal Health since 2009. She joined Pfizer in 1998 and has held various legal and compliance positions, including lead counsel for Pfizer's Established Products business unit.

Catherine Knupp has led Zoetis' and Pfizer Animal Health's R&D efforts since 2005.
In her role as President of Research and Development, Catherine Knupp is responsible for managing global R&D activities in support of discovering and registering new medicines and vaccines for dogs, cats, and livestock species,

and optimizing R&D performance. Knupp is a veterinarian by training.

Kristen Peck holds a number of roles at Zoetis.
Kristen Peck is responsible for Global Manufacturing and Supply, Global Poultry, Global Diagnostics, Corporate Development and new Product Marketing, and Global Market Research. Peck previously served as EVP of Worldwide Business Development and Innovation at Pfizer and as a member of Pfizer's Executive Leadership Team.

Country heads each have several years of animal experience.
Clint Lewis, Executive Vice President and President of U.S. Operations, has five years of animal health experience and served as the chairman of the Animal Health Institute (AHI) during the 2011-2012 term. In his current role, Lewis overseas Zoetis' livestock and companion animal businesses and is also responsible for the global genetics business.

Alejandro Bernal, Executive Vice President and Area President of the Europe, Africa, and Middle East region, is a veterinarian by training has 16 years of animal health experience. Prior to his current role, Bernal served as area president of Canada/ Latin America.

Joyce Lee, Executive Vice President and Area President of Canada and Latin America region, has 13 years of animal health experience and was previously vice president of PAH's Global Poultry division.

Stefan Weiskopf, Executive Vice President and Area President, Asia Pacific region, is a veterinarian by training and has 29 years of animal health experience. He was previously responsible for PAH's operations in Germany, Austria, and Switzerland.

Zoetis' Equity and Incentive Plan seeks to align mgmt. interests with shareholders longer-term.
Before executives can sell shares upon the exercise of options or vesting of other awards, Zoetis requires key executives to hold shares with a total value equal to a multiple of their base salaries. CEO Alaix must hold shares with a value equal to 5x his annual base salary ($614K in '12E) and CFO Passov and Head of BD Kristen Peck must hold Zoetis shares with a value of 3x their respective base salaries ($588K and $526K in '12E, respectively). In addition, other executives are required to hold Zoetis shares equal to 2x their base respective salaries. A caveat is that executives have 5 years to achieve this share ownership requirement.

Valuation and Comparables

We see Zoetis shares as fairly valued on 2014E P/E and EV/ EBITDA
Our base case valuation of $35/share is 21x our 2014E EPS of $1.65 and 14.7x our 2014E EBITDA of $1.4B. ZTS shares are currently trading in-line with the highest multiple Large-Cap Growth and SMID-Cap Animal Health companies in our comparables universe. Given ZTS's premium multiple on EPS and EBITDA, we believe material earnings upside is necessary for stock outperformance.

Bull case assumes significant earnings upside
Our bull case assumes Zoetis can earn in 2014E what we project in 2015E (EBITDA of $1.57B and EPS of $1.87). Bull case valuation of $41 is 22x our bull case 2014E EPS of $1.87 and 15x our bull case 2014E EBITDA of $1.57B.

Bear case assumes margin expansion fails to materialize
Our bear case assumes margin expansion does not materialize (2014E EBITDA margins in-line with 2013E of 27.3%). Bear case valuation of $29 is 19x our bear case 2014E EPS of $1.53 and 13x our bear case 2014E EBITDA of $1.3B.

ZTS has no directs comps; our comps table incl. SMID-Cap Animal Health and Large-Cap Growth Market Leaders
Valuation is a challenge because Zoetis has no publicly- traded large cap animal health peer. SMID-cap animal companies are either ex-U.S. (Virbac, Genus, Vetoquinol), closely held (Virbac and Vetoquinol), or more focused on distribution/ vet services (Idexx, VCA, MWI, Genus). Each has a lower EBITDA margin than Zoetis. As a result, we have expanded our comps universe to include Large-Cap Growth companies in other verticals with similar margins and growth outlook as Zoetis. Companies like Monsanto and Syngenta are market leaders in agriculture; Allergan, Perrigo, and Novo Nordisk are leaders in healthcare (Botox, store brands, and diabetes respectively); Mead Johnson (split off from Bristol Myers in 2009) is a leader in pediatric nutrition.

Interestingly, Large Cap Growth and SMID-Cap Animal Health companies have similar valuations.
On consensus' 2014E EPS, Large Cap Growth companies trade at 18.3x and SMID-Cap Animal Health companies trade at18.9x. On consensus' 2014E EBITDA, Large Cap Growth companies trade at 12.2x (range 10-14x) and SMID-Cap Animal Health companies trade at 11.0x (range 6-15x). On a consolidated basis, our comparables universe trades at 18.6x 2014E EPS and 11.6x 2014E EBITDA.

ZTS is currently trading in-line with the highest multiple Large Cap Growth and SMID-Cap Animal Health companies in our comparables universe.
ZTS is currently trading at 20.4x our 2014E EPS and 14.3x our 2014E EBITDA. This compares to Idexx in SMID-Cap Animal Health and Mead Johnson in Large Cap Growth.

Idexx Laboratories is a $5B EV market leader in diagnostics and information technology solutions for animal health and water and milk quality. Shares currently trade at 23.4x cons' 2014E EPS and 13.8x cons' 2014E EBITDA. Idexx has high margins (cons. projects 2014E EBITDA margins of 25%) and a robust long-term growth outlook (cons. projects LT EPS growth of 15%).

Mead Johnson is a $16B EV market leader in pediatric nutrition. The company was spun off from Bristol Myers in 2009. MJN and ZTS both trade around 20x 2014E EPS and 14x 2014E EBITDA. Relative to Zoetis, Mead Johnson has a higher dividend yield (1.9%vs. 0.8% for ZTS), more exposure to emerging markets (67% of total revs. vs. 27%), and a better revenue growth outlook (+8.4% rev. CAGR in '13-15E vs. +6%). However, Zoetis has a better EBITDA growth outlook than MJN (+14% EBITDA CAGR in '13-'15E vs. + 11%) and higher projected EBITDA margins (29% in '14E vs. 26%).

Insights from Mead Johnson's historical forward P/E and EV/EBITDA
Mead Johnson's forward P/E (based upon Thomson NTM consensus EPS) has averaged 21x since IPO in early 2009 (range 14x following IPO to 26x in April 2012). On EV/ EBITDA, MJN has averaged 14x since IPO. For comparison, ZTS shares are currently trading at 24x our 2013E EPS and 16x our 2013E EBITDA. See charts on page 17.

Comparison to Consumer stocks also suggests premium valuation for Zoetis.
We also compared Zoetis' forward multiple to Consumer Staples and Consumer Discretionary names (see chart on p. 18). According to data from our Strategy Team, Consumer Staples and Consumer Discretionary U.S. stocks trade around 16x forward earnings, again a significant premium to ZTS at 24x our 2013E EPS est.

Exhibit 9

Comparables

($USD, millions)							2013E*			2014E*			2013E-2015E CAGR*		EBITDA Margin*	
Ticker	Company Name	Description	Mkt Cap†	Net Debt‡	EV	Div. Yield	EV/ Rev	EV/ EBITDA	P/E	EV/ Rev	EV/ EBITDA	P/E	Revenue	EBITDA	2013E	2014E
Large-Cap Growth																
MON	Monsanto	Agriculture	55,867	-2,867	53,000	1.5%	3.6x	12.3x	22.6x	3.3x	11.1x	20.0x	7.3%	12.0%	29%	30%
SYT	Syngenta	Agriculture	39,963	1,498	41,461	2.0%	2.7x	11.6x	16.8x	2.5x	10.4x	13.2x	3.3%	4.2%	23%	24%
AGN	Allergan	Botox	33,585	-1,401	32,184	0.2%	5.2x	14.5x	23.1x	4.8x	12.8x	20.2x	7.5%	9.8%	36%	38%
MJN	Mead Johnson	Infant Formula	14,548	668	15,216	1.9%	3.7x	14.5x	21.7x	3.4x	13.0x	19.2x	8.4%	11.0%	25%	26%
PRGO	Perrigo	Store brands	11,107	905	12,013	0.3%	3.3x	13.4x	20.9x	3.0x	11.8x	17.9x	9.9%	12.5%	25%	25%
NOVO B	Novo Nordisk	Diabetes	95,429	-2,883	92,545	1.8%	6.3x	15.4x	21.6x	5.8x	13.9x	19.4x	8.0%	9.4%	41%	42%
Mean						1.3%	4.1x	13.6x	21.1x	3.8x	12.2x	18.3x	7%	10%	30%	31%
SMID-Cap Animal Health																
IDXX	Idexx Laboratories	Diagnostics	5,105	-12	5,094	0.0%	3.6x	15.3x	25.9x	3.4x	13.8x	23.4x	N/A	N/A	24%	25%
WOOF	VCA Antech	Vet clinics	2,046	560	2,606	0.0%	1.4x	8.3x	15.5x	1.3x	7.7x	14.0x	N/A	N/A	17%	17%
VIRP	Virbac (France)	Pharma	1,821	108	1,930	1.1%	1.9x	9.9x	18.8x	1.8x	9.2x	17.1x	9.1%	17.6%	19%	19%
MWIV	MWI Veterinary	Distribution	1,674	52	1,727	0.0%	0.7x	15.8x	27.2x	0.7x	14.0x	24.2x	11.2%	15.1%	5%	5%
GNS	Genus (UK)	Genetics	1,406	95	1,502	1.0%	2.8x	18.0x	27.4x	2.6x	15.7x	23.7x	9.2%	12.0%	16%	16%
VETO	Vetoquinol (France)	Pharma	385	-36	349	1.3%	0.8x	5.9x	11.9x	0.8x	5.5x	10.9x	3.3%	N/A	14%	15%
Mean						0.6%	1.9x	12.2x	21.1x	1.8x	11.0x	18.9x			16%	16%
Consolidated Mean						0.9%	3.0x	12.9x	21.1x	2.8x	11.6x	18.6x			21%	22%
	S&P 500								14.4x			13.4x				
ZTS	Zoetis	Animal pharma	16,964	3,322	20,286	0.8%	4.5x	16.3x	24.1x	4.2x	14.3x	20.4x	5.9%	14.1%	27%	29%

Source: ThomsonReuters (comparables), Morgan Stanley Research (Zoetis estimates) as of 3/12/13

† Market cap based upon fully diluted share count ‡ Net debt calculated using cash and short-term investments *Based upon consensus estimates

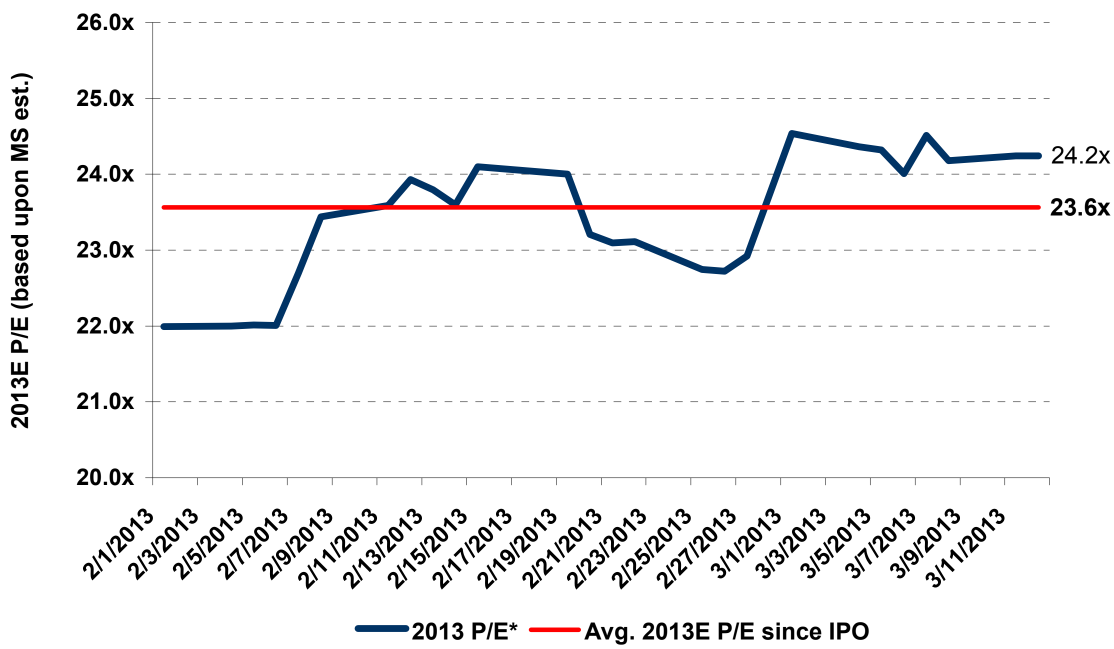
Notes: (1) VIRP and VETO report in Euros, Genus reports in British Pounds, and Novo reports in Danish Krones; EV calculated using current USD spot rates.

(2) GNS and PRGO fiscal year ends in June, MON FY ends in August, and MWI FYends in September.

Source: Thomson Reuters, Morgan Stanley Research estimates

Exhibit 10

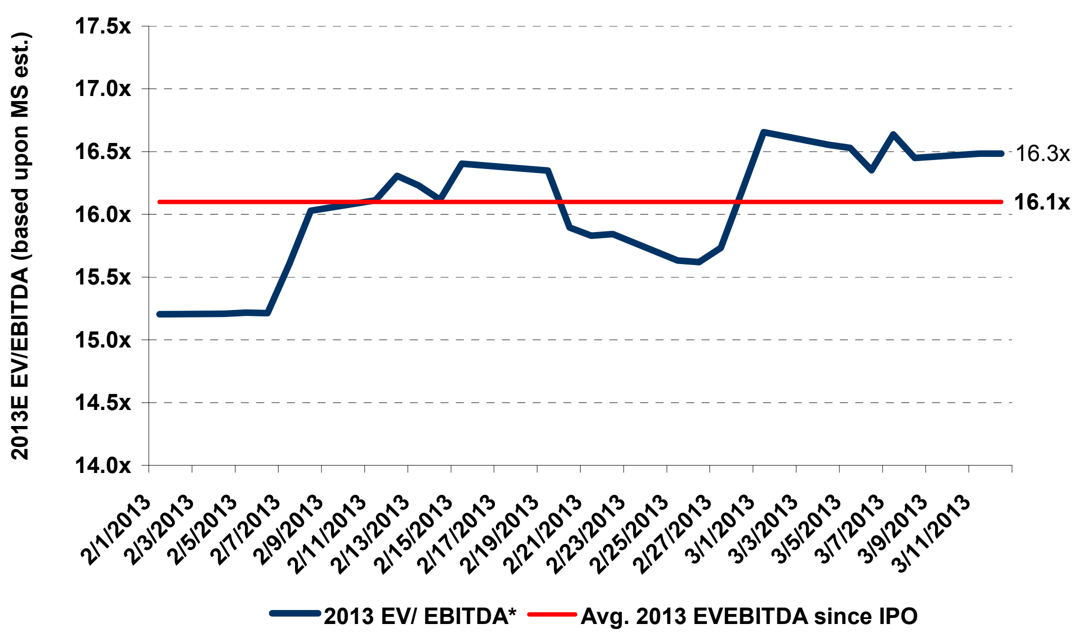
ZTS shares are currently trading at 24x our 2013E EPS of $1.41



*Based upon MS 2013E EPS estimate of $1.41
Source: Thomson Reuters, Morgan Stanley Research

Exhibit 11

ZTS shares are currently trading at 16x our 2013E EBITDA of $1.24B



*Based upon MS 2013E EBITDA estimate of $1.24B
Source: Thomson Reuters, Morgan Stanley Research

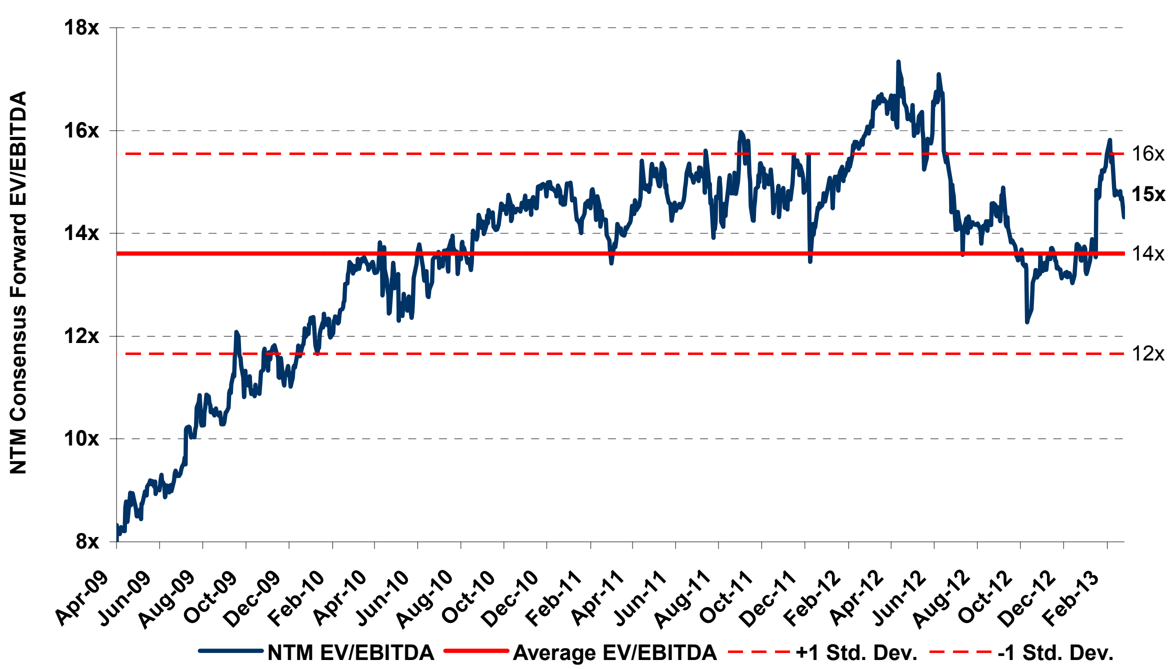
Exhibit 12

MJN forward P/E since IPO in early 2009 has averaged 21x

Source: Thomson Reuters, Morgan Stanley Research

Exhibit 13

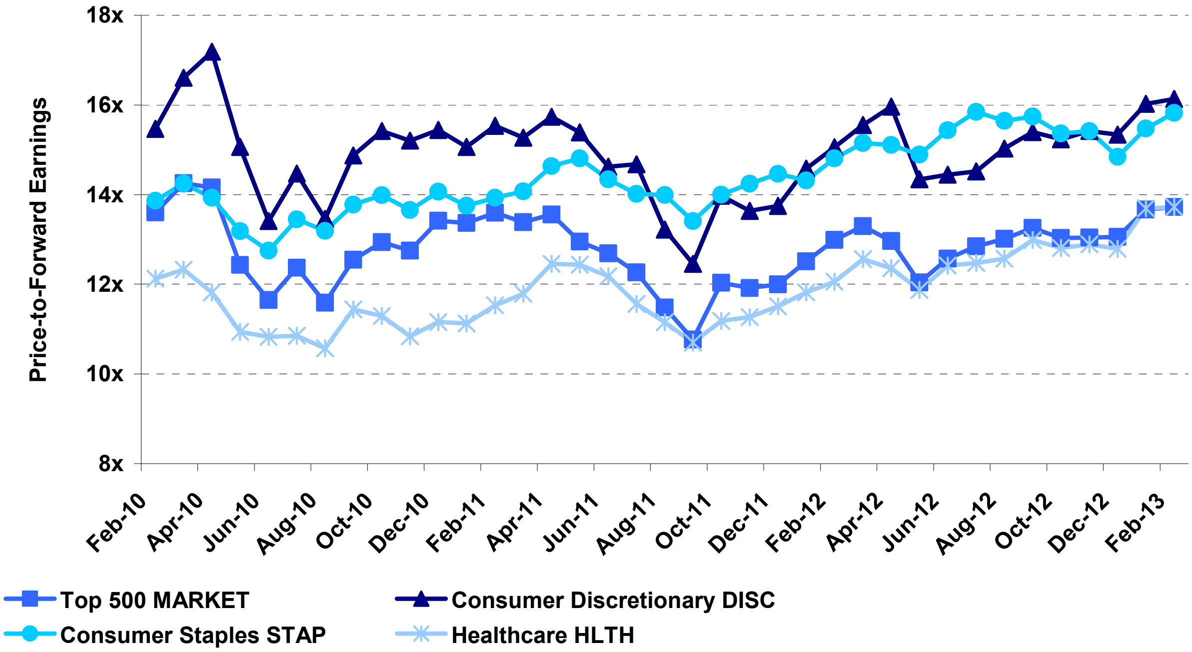
MJN forward EV/EBITDA since IPO in early 2009 has averaged 14x



Source: Thomson Reuters, Morgan Stanley Research

Exhibit 14

At 24x 2013E earnings, Zoetis trades at a material premium to the top 500 U.S. equities, including consumer discretionary, consumer staples, and health care



Source: Morgan Stanley Strategy Team

1) What is Zoetis' operating margin expansion potential?

BULL CASE

Bulls point to Zoetis' 29 manufacturing sites, 200 contract manufacturers and further potential synergies from the Wyeth Fort Dodge and King Animal Health acquisitions as sources of greater-than- expected margin upside. Bulls also point to Sanofi/ Merial's 31% O.M. (vs. ZTS' 2012E OM of 22%) as a benchmark for future upside.

BEAR CASE

Zoetis' adjusted operating margins have expanded 1000 b.p. from 11.6% in 2009A to 21.9% in 2012E and may only trend up marginally higher from current levels. In addition, the loss of Pfizer's buying power, incremental stand-alone/ public company costs, and a 15% markup on Pfizer-supplied products after 2014 could be underappreciated headwinds.

MARKET'S VIEW

Investors are generally bullish on Zoetis' margin outlook, but look forward to greater clarity from management on specific cost savings and/ or efficiency opportunities.

OUR VIEW

We project 200 b.p. of annual operating margin expansion in 2013-2015E as Zoetis' realizes operating leverage from list price increases, greater capacity utilization, sales force productivity, and prudent R&D expense management.

WHERE WE COULD BE WRONG

Operating margin expansion may fail to materialize; SAP implementation could cause financial hiccups.

LEADING INDICATORS

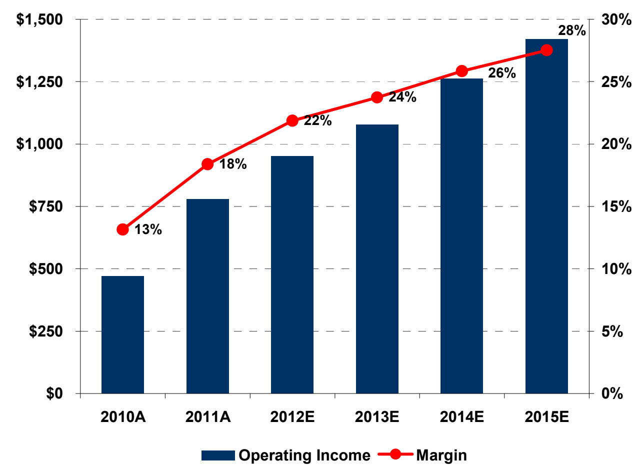
Quarterly performance and mgmt. commentary on potential cost savings/ efficiency initiatives

We model 200 b.p. of annual operating margin expansion in 2013-2015E.

We project operating margins to expand from 21.9% in 2012E to 27.5% in 2015E (EBITDA margins from 25.8% to 30.5%). This implies that for every $1 of sales growth, $0.50-$0.60 flows through pretax income. We expect management to realize significant operating leverage from list price increases, greater capacity utilization, sales force productivity gains, and prudent R&D investment. Given what is effectively a branded generic business model, we think a 28% operating margin is attainable relative to leading global pharma companies with a 40% O.M. and leading global pure play generic businesses with a 20-30% O.M.

Exhibit 15

We project 200 b.p. of annual operating margin expansion in 2013-2015E



Source: Company Data, Morgan Stanley Research estimates

We do not expect incremental stand-alone/ pubic company costs to impede margin expansion.

As a business unit of Pfizer, Zoetis' historical financials already included an allocation of corporate, manufacturing and shared services costs. Under the terms of the transitional services agreement with Pfizer, Zoetis has the right to leverage certain business technology, facilities, finance, human resources, public affairs and procurement capabilities from Pfizer. The markup for these services will be 0% for the first two years after the separation and 7% thereafter. However, Zoetis has the right to terminate the agreement early, and management is investing in the creation of a standalone infrastructure. These one-time costs ($200-$240M in '13E and $100-$140M in '14E) are excluded from non-GAAP EPS. However, incremental costs of $15-$25M related to standalone public company costs in excess of what was historically allocated by Pfizer are not excluded from adjusted EPS. Mgmt. is committed to offsetting these "dis-synergies" via prudent expense mgmt (e.g., smaller real estate footprint at corporate headquarters in New Jersey).

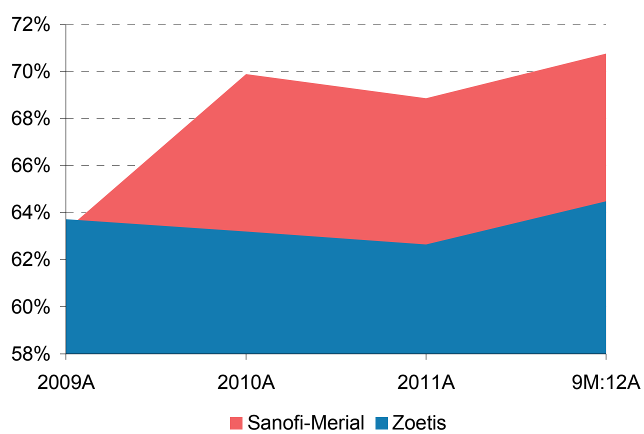
Gross margins

List price increases and greater capacity utilization are key drivers of gross margin expansion

We model 220 b.p. of cumulative gross margin expansion in 2012-2015E, including 150 b.p. from list price increases and 70 b.p. from increased capacity utilization. According to mgmt., Zoetis raises list prices in-line with the market at 2%+ per year, and the vast majority flows through the bottom line. Assuming 2.5% annual price increases and 1% growth in COGS, gross margins should theoretically expand 150 b.p. in 2012-2015E holding sales volumes constant (i.e., zero volume growth). But as sales volumes increase, gross margins should benefit from increased capacity utilization (i.e., fixed costs spread over a greater volume of production units), which we estimate should drive an additional 70 b.p. of gross margin expansion in 2012-2015E. Caveats are that we have not confirmed with management our 1% COGS inflation estimate, and we do not know current plant utilization or production capacity.

Exhibit 16

Zoetis' gross margin is unlikely to reach Sanofi-Merial's 70%+ because a greater percentage of ZTS sales come from lower-margin livestock products



Source: Company Data, Morgan Stanley Research

We do not expect Zoetis' G.M. to expand to Sanofi's 70% level near-term due to differences in business mix

For the 9-months ended Sep. 30, 2012, Sanofi's Merial gross margin was 70.8%. This compared to Zoetis' gross margin of 64.5% over the same period. However, it is important to note that roughly 2/3 of Merial sales come from Companion Animals (vs. 35% for Zoetis). Margins on companion animal products are higher than livestock products on average. According to our channel checks, margins on blockbuster companion animal products, like Merial's FrontLine flea/tick (36% of total Merial sales), are 90%+ vs. 50%-range for livestock products.

We do not expect mgmt. to significantly consolidate its company-owned manufacturing footprint

Zoetis has 29 company-owned manufacturing sites in 11 countries, including 13 "anchor" sites and 16 "satellite sites" which manufacture products that account for 58% of total COGS. Some bulls may expect Zoetis to realize significant cost savings from plant rationalization. However, according to management, Zoetis' expansive facility footprint is necessary to remain close to certain key customers globally, and it is important that the production of certain products (e.g., vaccines) remain separate in order to ensure quality control.

However, we do expect mgmt. to scrutinize its network of CMOs for efficiency opportunities

Zoetis utilizes 200 contract manufacturers. While we are not aware of specific cost initiatives related to Zoetis' CMO network, the S1 states that mgmt. intends to "continue our efficiency improvement programs in our manufacturing and supply chain organization, including Six Sigma and Lean capabilities, which are processes intended to improve manufacturing efficiency." According to mgmt., some of these CMOs are relatively small, and there is some flexibility on price.

We expect Zoetis to offset the 15% markup on Pfizer-supplied products that kicks in after 2014.

In addition to the company's 29 manufacturing sites and 200 CMOs, Zoetis leverages 14 Pfizer-owned sites in 13 countries. Under the agreement related to Pfizer-supplied products, there is a 0% markup on Pfizer's costs during the first two years after the separation. However, Zoetis will pay a 15% markup after 2014. Zoetis may terminate the agreement upon at least six months' prior notice. According to the S1, "the decision to continue manufacturing our products at Pfizer sties will be reevaluated in the future based upon several factors, including manufacturing costs and the needs of business."

R&D and SG&A

Zoetis should realize a majority of operating leverage from R&D and SG&A.

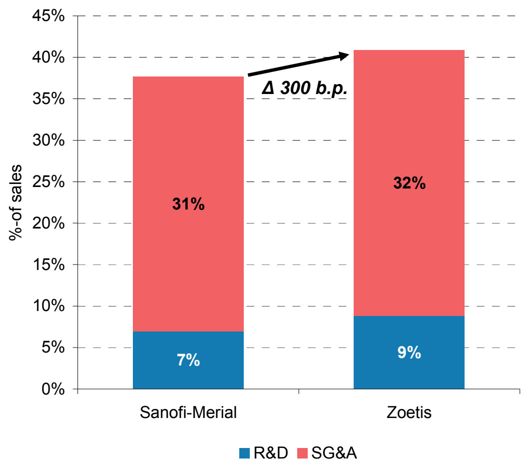
We project total R&D and SG&A to decline from 41.6% of sales in 2012E to 38.2% in 2015E. Zoetis should realize significant operating leverage from its sales and R&D infrastructure in the coming years, particularly in high-growth emerging markets (27% of 2011A revenues).

Zoetis spends more in R&D and SG&A than Sanofi- Merial

For the 9-months ended Sep. 30, 2012, Zoetis spent 41% of sales on R&D and SG&A vs. 38% for Merial. Greater investment in R&D accounted for 200 b.p. of the difference, and higher SG&A accounted for roughly 100 b.p. Bulls may point to Merial's lower investment in R&D as a percentage of sales as a potential cost savings opportunity for Zoetis.

Exhibit 17

Zoetis spends more in R&D and SG&A as a percentage of sales than Sanofi's Merial



For the 9 months ended Sep. 30, 2012
Source: Company Data, Morgan Stanley Research

Zoetis has no plans to materially increase the size of its sales force.
Zoetis currently has approximately 3,400 sales representatives in approximately 70 countries across North America, Europe, Africa, Asia, Australia and Latin America. Notably, Zoetis' S1 makes reference to the company's "efforts to establish an early and direct presence in many emerging markets, such as Brazil, China and India." According to management, Zoetis has the "right" sales infrastructure in place to capture double-digit growth in emerging markets without the need to materially increase the size of its sales force. While management has not disclosed sales force numbers by geography, we expect sales force productivity to increase significantly in coming years.

We do not foresee a major inflection in R&D spending.
The majority of Zoetis' R&D efforts are focused on brand lifecycle management that "leverage existing animal health products by adding new species or claims, achieving approvals in new markets or creating new combination and reformulations." The average animal health development program costs $6-8M over a period of 5-6 years (per industry sources).

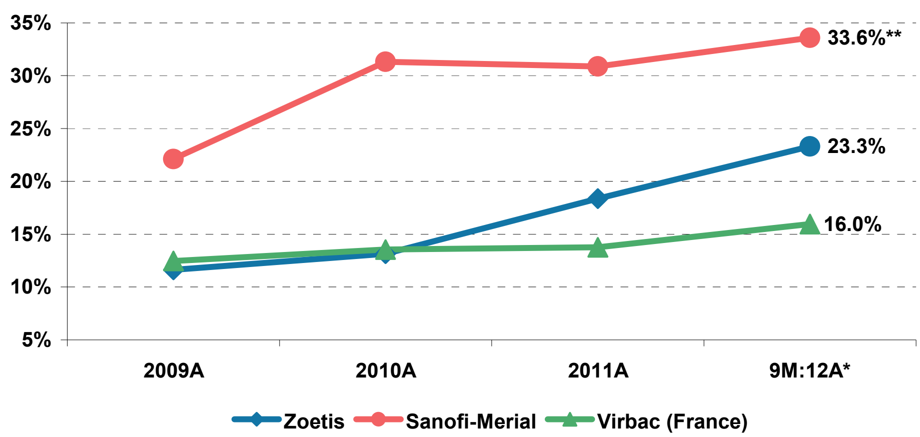
We do not believe blockbuster innovation and blockbuster R&D budgets are necessary to support LT growth.
Hence, we model R&D as a percentage of sales declining from 9.1% in 2012E to 8.6% in 2015E. For comparison, Sanofi's Merial currently invests 7.5% of revenues in R&D. Despite a decline in R&D as a percentage of sales, we project a 4% CAGR in R&D spending in 2012-2015E. We believe our 2015E R&D of $440M is a reasonable projection, but spending efficiencies could yield a figure below our forecast.

SAP implementation is a potential risk to watch

SAP implementation could cause financial hiccups
Zoetis is still in the early stages of SAP implementation, and management targets completion in 2+ years. While Zoetis has not detailed specific spending, SAP is a component of the $30-$40M one-time internal costs highlighted by management in the S1. In addition, portions of elevated capex in 2013-2014 are also related to SAP implementation.

Exhibit 18

Operating Margin Comparison: Zoetis vs. Merial vs. Virbac (publicly traded French animal pharma company)



*Virbac operating margin is for 1H:12A **Merial full-year 2012 O.M. was 30.9%
Source: Company Data, Morgan Stanley Research

2) What is the risk of increased government regulations on livestock antibiotics?

BULL CASE

Regulations are unlikely to impede financial performance because FDA guidance is voluntary and affects a small portion of Zoetis' global revenues.

BEAR CASE

Global regulations on additional uses of antibiotics, including disease prevention, could threaten up to 30% of total company revenues.

MARKET'S VIEW

Investors believe increased regulations are mainly a headline risk, but struggle to quantify ZTS' theoretical revenue exposure.

OUR VIEW

We believe only 3% of global revenues are at risk to increased U.S. govt. regulations on the use of antibiotics. In addition, recently proposed U.S. legislation seeking enhanced disclosure of antibiotics usage is less ambitious than previous failed attempts to ban non-therapeutic uses (e.g., for growth promotion). We will continue to watch developments in Europe and Asia.

WHERE WE COULD BE WRONG

U.S. regulations could be more stringent and/or financially punitive than we expect.

LEADING INDICATORS

FDA communication; Congressional action; ex-U.S. developments in Asia and Europe

We believe only 3% of global revenues are at risk to increased govt. regulations on antibiotics in the U.S.
April 2012 FDA guidance calls for the voluntary elimination of medically important antibiotics used for growth promotion in food-producing animals. Industry experts believe these changes will be phased in over the next 3-5 years. In terms of quantifying the potential risk, recall that Zoetis reported global livestock antibacterials sales of $1.2B in 2011A. Across all indications, this represented approximately 28% of global revenues. However, we estimate that antibiotics used for growth promotion in the U.S. accounted for just 3% of global revenues. This assumes that 40% of global antibacterial sales are in the U.S., of which 25% are used for growth promotion (hence, 28% * 40% * 25% = 3%). Our estimate for growth promotion is based upon an average of data from various stakeholder groups and our analysis of a recent study of in-feed antimicrobials used in swine production.

Overview of recent FDA guidance

FDA is concerned about antibiotic resistance in humans
The relationship between antibiotic use in livestock and the development antibiotic-resistant infections in humans has been the subject of ongoing debate for the last 40 years. FDA is concerned about the "development of antimicrobial resistance in human and animal bacterial pathogens when medically important antimicrobial drugs are used in food-producing animals in an injudicious manner."

FDA guidance calls for the <u>voluntary</u> elimination of certain antimicrobials used for growth promotion in livestock
Final FDA guidance (#209) in April 2012 calls for the voluntary elimination of medically important antimicrobials used for growth promotion in food-producing animals. Guidance does not directly impact therapeutic uses (i.e., treatment control, and prevention) of medically important antibiotics. In addition, FDA guidance calls for the voluntary phase-in of veterinary oversight or consultation (many antimicrobials are available OTC). According to the Animal Health Institute, an industry trade group representing animal health manufacturers, all changes will be phased in over the next 3-5 years.

FDA also seeks revised product labeling for medically important drugs
Also in Apr. '12, FDA issued draft guidance (#213) that calls for the voluntary elimination of growth promotion or feed efficiency claims from drug labels over a 3-year period following the publication of final guidance. However, AHI notes that drug sponsors could seek new claims on compounds where growth claims exist without prevention claims.

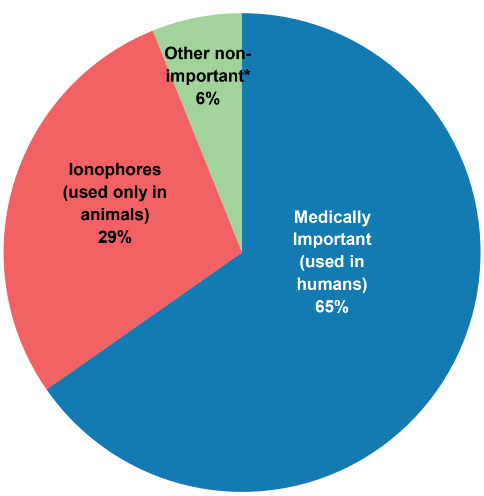
Important risk considerations

Guidance only affects <u>medically important</u> antibacterials used in feed/water for <u>growth promotion</u>
FDA's voluntary strategy is primarily focused on medically important antibiotics that are 1) used in food producing animals to increase feed efficiency and promote growth that 2) are available over-the-counter, and 3) are given continuously through the feed or water to entire herds or flocks of animals. "Medically important" refers to antibiotics that are important for therapeutic use in humans (e.g., penicillin, cephalosporin, macrolides and tetracycline).

Guidance does not affect therapeutic uses, including prophylaxis
Guidance #209 states: "FDA considers uses that are associated with the treatment, control, or prevention of specific diseases, including administration through feed or water, to be uses that are necessary for assuring the health of food producing animals." FDA defines disease prevention as "the administration of an antimicrobial drug to animals, none of which are exhibiting clinical signs of disease, in a situation where disease is likely to occur if the drug is not administered."

Guidance does not affect non-important antibiotics which accounted for 35% of total antimicrobials sold (by weight)
Non- medically important antibiotics such as ionophores (e.g., Zoetis' Bovatec) and bacitracin are not covered by FDA's Apr. 2012 guidance. Ionophores, which are used in livestock to improve feed efficiency by aiding digestion, are not used in humans, and bacitracin is only used for minor skin or eye infections in humans. According to a Dec. 2010 FDA report on antimicrobials (link: here), ionophores accounted for 29% of all domestic sales (by weight) of antimicrobial drugs approved for livestock use in 2009. In a subsequent April 2011 letter to Rep. Louise Slaughter (link: here), FDA reported that other antibiotics used exclusively in animal medicine (e.g., aminocoumarins, glycolipids, and quinoxalines) accounted for an additional 6% of total antimicrobial used in livestock.

Exhibit 19
Non- Medically Important Antibiotics used exclusively in animals accounted for 35% (by weight) of total U.S. livestock antimicrobials in 2009



*Includes other antibiotics used exclusively in animal medicine (e.g., aminocoumarins, glycolipids, quinoxalines)
Source: FDA, Morgan Stanley Research

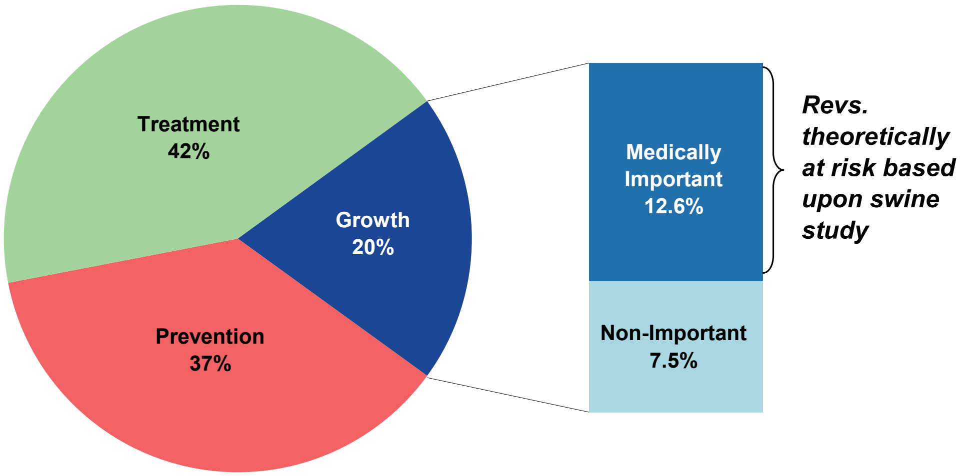
Estimates of antibiotics used for growth promotion range from 13% to 70%.
According to data from the Congressional Research Service (CRS, link: here), a 2001 report by the Union of Concerned Scientists (UCS) asserted that 70% of all antibiotics produced in the U.S. were used for non-therapeutic purposes in food animals. The Animal Health Institute (AHI) refuted this claim, arguing (among other things) that UCS' data included ionophores (not used in humans). Excluding ionophores (approx. 29% of all antibiotics used in livestock in 2009), UCS statistics imply 40% of antibiotics are at risk for growth promotion. But according to an AHI survey of its members, only 13% of antibiotics were used for non-therapeutic uses.

Recent analysis of antimicrobial use in swine suggests minimal risk to animal health manufacturers
AHI data appears generally consistent with a Nov. 2012 analysis, "Use Estimates of In-Feed Antimicrobials in Swine Production in the United States" published in Foodborne Pathogens and Disease (link: here). According to data we analyzed, growth promotion accounted for 20% of total estimated antimicrobial use in U.S. swine. Growth antibiotics classified as medically important, which are theoretically at risk under FDA guidance, accounted for just 13% of total estimated in-feed antimicrobials used for growth promotion. Caveat is that input data was obtained from surveys that could be subject to self-reporting biases.

Data from Denmark suggests theoretically greater risk
Denmark banned antibiotics used for growth promotion in 1998. However, antibiotics usage had been on the decline since 1994-1995 after Denmark placed limitations on veterinarian profits from sales of medicines and increased regulations that affected the use of tetracyclines. According to data from DANMAP, The Danish Integrated Antimicrobial Resistance Monitoring and Research Program (link: here), overall consumption of antibiotics in food producing animals declined 51% between 1994 and 2011. While total consumption decreased, it is interesting to note an increase in therapeutic uses of antibiotics following the ban on growth promotion (see chart on page 24).

Exhibit 20

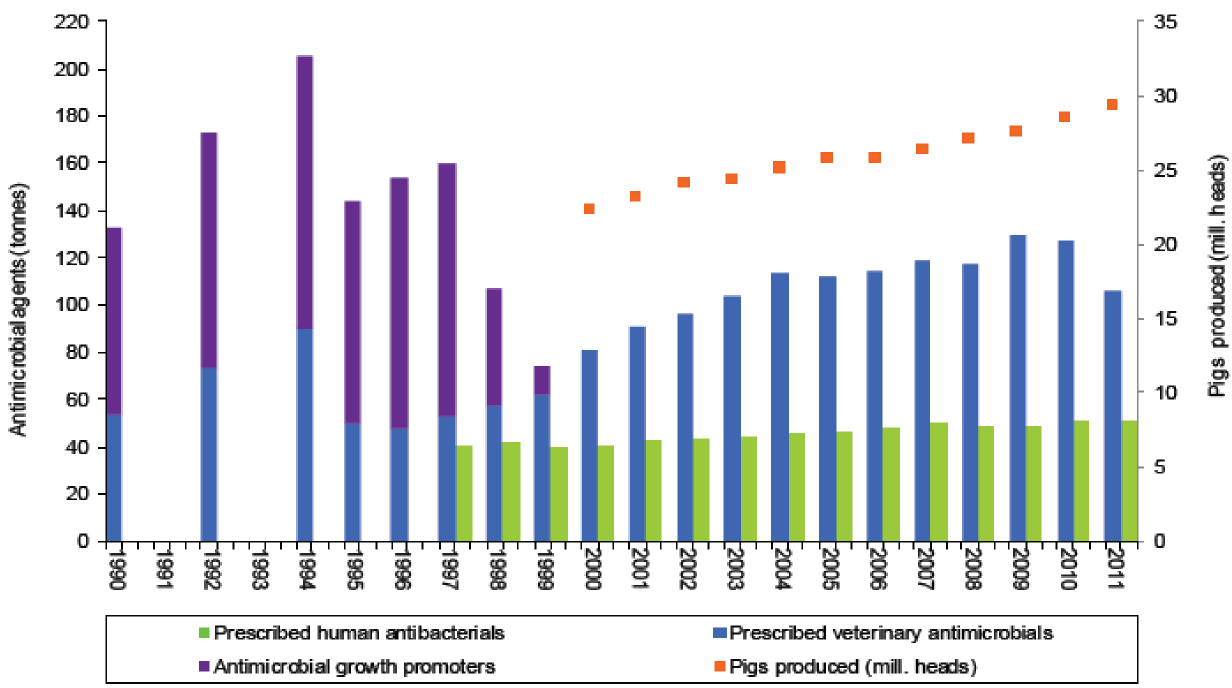
Growth promotion accounted for 20% of total estimated antibiotics used in U.S. swine, including 13% classified as medically important (theoretically at risk under new regulations) and 8% classified as non-important



Source: Apley, Michael, et. al, "Use Estimates of In-Feed Antimicrobials in Swine Production in the United States," *Foodborne Pathogens and Disease* 9.3 (2012), Morgan Stanley Research

Exhibit 21

However, the use of antimicrobials in pig production in Denmark declined significantly after the govt. banned growth promoters in 1998, but note an uptick in antimicrobials used for therapeutic uses following the ban



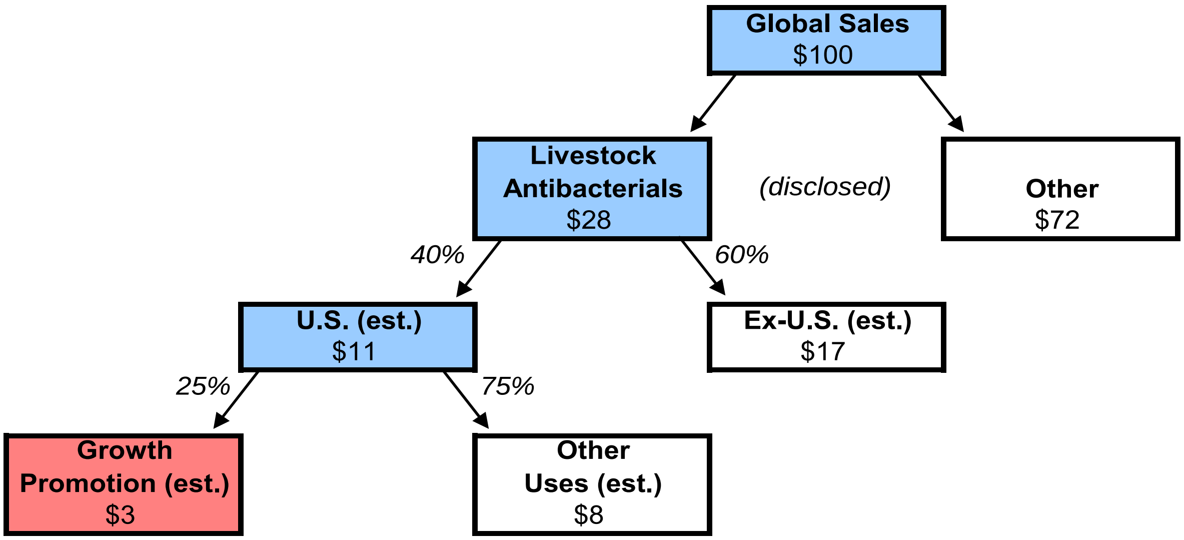
Sources: Human therapeutics: The Danish Medicines Agency. Veterinary consumption: 1990–2000 data based on reports from the pharmaceutical industry of total annual sales; 1990–1994 data from 'Use of antibiotics in the pig production' [Federation of Danish pig producers and slaughterhouses. N. E. Rønn (Ed.)]; 1996–2000 data from Danish Medicines Agency and Danish Plant Directorate; 2001–2011 data from VetStat

Source: Danish Integrated Antimicrobial Resistance Monitoring and Research Program, 2011

MS quantification

Exhibit 22

We estimate that 3% of global revenues are at risk to U.S. regulations restricting the use of U.S. livestock antibacterials for growth promotion



Global sales indexed to $100
Source: Company Data, Morgan Stanley Research

Global livestock antibacterials accounted for 28% of 2011A revenues; mgmt. says antibacterials marketed exclusively for growth promotion are <1% of global revs.
According to the S1, global sales of livestock antibacterials were $1.2B in 2011A. This represents approximately 28% of global revenues. Zoetis has not disclosed sales of livestock antibacterials by region. However, management has stated that sales of livestock antibacterials labeled exclusively for growth promotion in the U.S. are insignificant and in the "tens of millions of dollars." That said, we note that farmers may use some antibiotics off label for growth promotion.

However, most antibiotics used for growth promotion have multiple claims.
While sales of antibiotics labeled exclusively for growth promotion may be insignificant, we must also asses the theoretical risk to sales of medically important antibiotics that have several indications, including growth as well as treatment, control and prevention of disease.

We est. U.S. livestock antibacterial sales are ~$500M.
According to Zoetis, the U.S. accounted for approximately 30% of 2011A total livestock sales across all product categories (e.g., parasiticides, medical feed additives, etc). However, we believe that the U.S. accounts for a higher proportion of livestock antibiotic sales in light of the 2006 EU ban on antibiotics sold for growth promotion. Assuming 40% of global livestock antibacterial sales are in the U.S., we estimate $500M of exposure.

We assume 25% of medically important U.S. livestock antibacterials are used for growth promotion.
This estimate is based upon a rough average of data presented by AHI and UCS (adjusted for ionophores) as well as our analysis from a recent study of in-feed antimicrobials in pigs. Note FDA guidance does not impact sales of antibiotics that have no use in humans. This includes products such as ionophores, which accounted for 29% of U.S. antibiotic sales (by weight) in 2009 according to FDA data. According to data we have analyzed from various stakeholder groups (both for and against the use of antibiotics in humans), approximately 10-40% of total U.S. antibiotics appear to be used for growth promotion.

Our assumptions imply only a 3% risk to global revenues.
We estimate that U.S. sales of medically important antibiotics used for growth promotion were approximately $125M in 2011. This implies risk to approximately 3% of 2011A total company revenue of $4.23B.

U.S. Congressional risk

Congressional action does not pose a significant risk, in our view

The leading opponent of antibiotics in food producing animals is Rep. Louise Slaughter (D-NY). Rep. Slaughter introduced The Preservation of Antibiotics for Medical Treatment Act in 2009 and again in 2011, but both bills died in the House. Slaughter's bill sought the elimination of "critical antimicrobial animal drugs" used for any "non-therapeutic use" within two years of passage.

Critical antimicrobial animal drugs include any antibiotics used in food-producing animals that are composed whole or partly of penicillin, tertracycline, macroide, lincosamide, streptogramin, aminoglycoside, and sulfonamide. In the Bill, non-therapeutic use is defined as use of antimicrobials "as a feed or water additive for an animal in the absence of any clinical sign of disease in the animal for growth promotion, feed efficiency, weight gain, routine disease prevention, or other routine purpose."

While the potential elimination of antibiotics for disease prevention is concerning, we view the risk as low because Rep. Slaughter's bill failed in both Republican and Democratic-controlled Congresses.

Recently introduced HR 820 is much less ambitious than Rep. Slaughter's previous bill

Reps. Waxman and Slaughter introduced HR 820, the Delivering Antimicrobial Transparency in Animals Act of 2013 (DATA Act), in Feb. 2013. The DATA Act seeks enhanced reporting requirements of antimicrobials sold, distributed and used in food producing animals. The bill would require animal health manufacturers to provide data to FDA on how antimicrobial drugs are used in food producing animals. In addition, the DATA Act would require poultry, swine, and livestock producers to report data on medicated feeds provided to their animals. Finally, the DATA Act would require FDA to finalize draft guidance #213, which seeks for the voluntary elimination of growth promotion or feed efficiency claims from drug labels. While enhanced disclosure could serve as spring board for additional regulations on antibiotics consumption, we believe the risk of the proposed legislation in and of itself is low.

Ex-U.S. risk

Antibiotics used for growth promotion have been banned in the EU since 2006; earlier in some countries.

Antibiotics for growth promotion were banned in the EU in 2006. Select countries instituted bans earlier, including Switzerland in 1999, Denmark in 1998, and Sweden in 1986. We understand that EU authorities are now scrutinizing prophylactic use of antibiotics, and may invoke restrictions under the precautionary principle. As defined in European legislation, the "precautionary principle may be invoked where urgent measures are needed in the face of a possible danger to human, animal or plant health, or to protect the environment where scientific data do not permit a complete evaluation of the risk." In recent years, the EU placed label restrictions on the use of fluoroquinolones and cephalosporins as first line therapy. We will continue to observe developments in Europe.

Asia presents opportunity despite recent negative press

Some investors are concerned about potential increased regulation in Asia following recent news reports (link: here) that links the KFC chain with alleged improper use of antibiotics in chicken supplied by Chinese companies. However, it is important to note that only 10% of animal health products in China are manufactured by multinational companies. As production in emerging markets becomes more industrialized (e.g., 85% of the 600M swine raised in China annual are from backyard farms), we see opportunities for more responsible production and market share gains by multinationals.

Pipeline opportunity

FDA guidance provides an incentive for the development of non-antibiotic growth promoters

According to a 2011 Pfizer Animal Health presentation on antibiotics (link: here), a non-human antimicrobial class (or unique analog) would be preferred to avoid cross-resistance with human use. Furthermore, a bactericidal mechanism would be preferred to a bacteriostatic mechanism to minimize co-resistance and cross-resistance selection. Finally, appropriate label directions would be necessary to guide end-users in the use of a product to ensure minimal (or no) food borne bacteria resistance selection.

3) Will new pharmacy entrants and Vet Rx legislation drive increased price pressure and generic substitution?

BULL CASE

Pet owners continue to purchase the vast majority of companion animal prescriptions from veterinary pharmacies, which have less pricing power than big box retailers or major pharmacy chains

BEAR CASE

H.R. 1406 (Fairness to Pet Owners Act) is revived, and results in pet owners having Vet Rx's filled at their local pharmacies. These pharmacies push increased generic substitution and other lower-cost alternatives which ultimately squeeze Zoetis' sales and margins. Perrigo makes inroads in OTC (non-prescription) products.

MARKET'S VIEW

Investors question whether the shift from vet office to online/ big box retailers and proposed Vet Rx legislation requiring mandatory written prescriptions will drive increased generic substitution and pressure companion animal Rx margins.

OUR VIEW

Dog and cat owners are no longer held captive to in-house vet pharmacies, but the vast majority of scripts are still filled in vet offices. Perrigo's niche efforts are focused on OTC flea and tick, which poses a limited risk to Zoetis. Even if HR 1406 is ultimately passed, we believe the risk is low because the majority of companion animal Rx's are injectables and/or for acute uses.

WHERE WE COULD BE WRONG

HR 1406 is passed into law and has a greater-than-expected market impact.

LEADING INDICATORS

Congressional (re-) action on HR 1406; Perrigo strategic action in animal health.

We believe the risk of channel shift is low

The majority of companion animal prescriptions are filled in vet offices, but there is a trend toward Big Box/ online retailers for select OTC products (i.e., flea and tick). In addition, recent legislation (HR 1406), if enacted, could have facilitated a shift to off-site pharmacies by requiring vets to provide written prescriptions to pet owners. Major chains such as CVS, Rite Aid, Walgreen, and Wal-Mart could theoretically exert more intense price pressure on animal health manufacturers than small or regional vet practices. However, we think the risk to Zoetis is low because: 1) Zoetis' flea and tick portfolio (e.g., Revolution) represents a small percentage of sales and EPS (undisclosed, but we est. single digit percentage), and 2) the majority (we estimate over two-thirds) of companion animal prescriptions are for injectables or acute indications where the convenience of on-site dispensing trumps potential cost savings from off-site pharmacies, in our view.

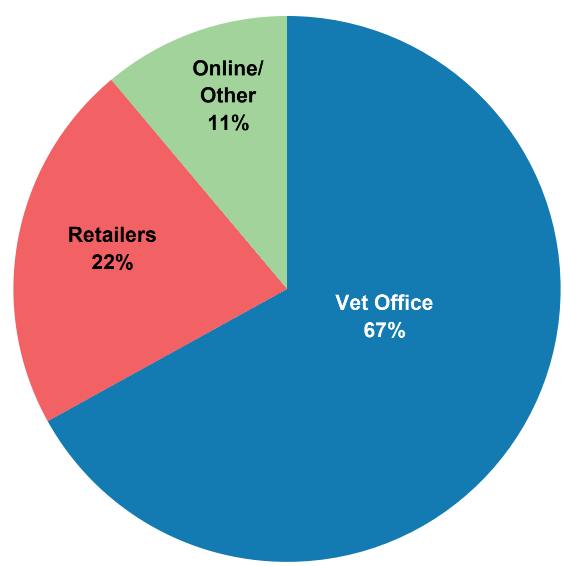
New channels could mean increased price competition for animal health makers

Pet owners are no longer held captive to in-house vet pharmacies for select products.

According to our channel checks, there are human health generic alternatives for 60-70% of the drugs that she prescribes (some classes, such as pain, do not have viable human health alternatives). And based upon our channel check, 15-20% of pet owners clients ask for cheaper alternatives. But the vast majority of scripts are still filled in vet offices. According to PetMed Express (Nasdaq: PETS; owner of 1-800-PetMeds), 67% of pet medications are filled in vet offices vs. 22% at retail and 11% at online/other mail order.

Exhibit 23

Nearly 1/3 of current animal health medications are purchased outside of the vet office pharmacy



Source: PETS Investor Presentation

We believe generics pose an evolutionary rather than revolutionary threat
Large human health generics companies, such as Teva and Ranbaxy, have exited animal health. Other pure play animal health companies, such as Putney, have struggled to make inroads with veterinarians. However, we do see a trend of flea and tick products gradually moving OTC. Sanofi Merial's FrontLine ($1B branded drug for flea/tick prevention) went off patent in 2011 spawning low cost alternatives such as Velcera's PetArmor and Sergeant's Sentry Fiproguard. Perrigo acquired Sergeant's in September 2012 and announced the acquisition of Velcera in Feb. 2013 in an effort to build out its leadership in the emerging OTC pet care market. However, we note that Sanofi has preserved roughly 90% of FrontLine U.S. sales in the wake of patent expiration.

Vet Rx legislation, if enacted, could result in greater competition from major drug retailers

Wal-Mart lobbied for HR 1406; legislation could theoretically be revived in the current Congress
HR 1406, Fairness to Pet Owners Act of 2011, was introduced in the 112th Congress by Rep. Jim Matheson (D-UT). The bill was referred to the House Energy and Commerce Committee's Subcommittee on Health, but died when the 112th Congress adjourned in January 2013. HR 1406 would require vets to give pet owners a written copy of their prescription (whether or not requested by the owner) and provide written notice that pet owners may fill prescriptions at an off-site pharmacy. In addition, vets would not be allowed to charge for a written copy of vet prescriptions or require a pet owner to sign a waiver or liability disclaimer should the prescription be inaccurately filled at an off-site pharmacy. Wal-Mart actively supported H.R. 1406 and sponsored a letter writing campaign in support of mandatory written vet prescriptions.

Wal-Mart and big pharmacy chains could squeeze margins and drive increased generic competition
Big box retailers and major pharmacy chains could drive increased substitution of companion animal or human health generic alternatives over time. These pharmacies will likely be tougher negotiators and could theoretically drive lower ASPs (average selling prices).

AVMA criticized HR 1406 for being redundant and encroaching upon States' rights
The American Veterinary Medical Association (AVMA) has argued that HR 1406 is redundant because the AVMA's Principles of Veterinary Medical Ethics states that vets should honor a client's request for a prescription. In addition, 27 states either explicitly require vets to provide written prescriptions upon request or have adopted the AVMA's code of ethics.

Although the threat of Vet Rx legislation would likely hurt ZTS's P/E multiple, we believe the financial impact would be modest

Even if resurrected and signed into law, we believe the risk from HR 1406 is low
This is because the majority of Zoetis' companion animal health prescriptions (we estimate over two-thirds) are either injectables or acute use drugs where the convenience of on-site dispensing will likely trump the potential cost savings from third-party pharmacies. However, passage of HR 1406 could pose greater risk to chronic use drugs (such as OTC flea/tick), where potential cost savings and convenience of mail-order may trump routine visits to the vet office.

According to our consultant, 80% of companion animal prescriptions are injectables or for acute uses,
According to our companion animal vet consultant, 40% of the drugs that her practice prescribes are for acute use, 40% are injectables, and 20% are for chronic uses. Acute care drugs include short-term antibiotics (e.g., Zoetis' Convenia, Cerenia), whereas chronic use drugs include flea and tick products (e.g., Zoetis' Revolution and Sanofi/ Merial's FrontLine).

Morgan Stanley Research Model

Exhibit 24

Annual Income Statement (1 of 2)

($M)	2009A	2010A	2011A	2012E	2013E	2014E	2015E
Net revenues	2,760	3,582	4,233	4,351	4,544	4,882	5,164
COGS	1,001	1,318	1,581	1,575	1,607	1,684	1,756
Gross profit	1,759	2,264	2,652	2,776	2,938	3,198	3,408
SG&A	1,057	1,365	1,447	1,412	1,441	1,499	1,529
R&D	365	411	407	396	402	422	443
Amortization of intangibles	16	17	20	17	16	15	15
Operating income	321	471	778	951	1,079	1,262	1,421
Other expense (income)	1	25	28	26	32	32	32
*Adjusted EBIT**	*322*	*496*	*806*	*977*	*1,111*	*1,294*	*1,453*
Depreciation	*42*	*86*	*95*	*130*	*115*	*110*	*105*
EBITDA	*363*	*599*	*921*	*1,124*	*1,242*	*1,419*	*1,573*
Other expenses/(income)	25	12	8	4	85	87	85
Interest expense	26	37	36	30	117	119	117
Other expense (income)	(1)	(25)	(28)	(26)	(32)	(32)	(32)
Pretax income	296	459	770	947	993	1,175	1,335
Taxes	108	183	264	325	288	341	387
Tax Rate	36.5%	39.9%	34.3%	34.3%	29.0%	29.0%	29.0%
Income attributable to non-controlling interest	(1)	1	3	-	-	-	-
Net income (Non-GAAP)	189	275	503	623	705	834	948
DILUTED EPS, proforma	$0.38	$0.55	$1.01	$1.25	$1.41	$1.65	$1.87
Diluted shares outstanding	500	500	500	500	502	504	507
Average basic shares outstanding	500	500	500	500	500	503	505
Period-end basic shares outstanding	500	500	500	500	500	503	505

We add back other income in the calc. of EBIT, but exclude from op. income b/c it is not an operating line item

Margin Analysis	2009A	2010A	2011A	2012E	2013E	2014E	2015E
COGS	36.3%	36.8%	37.3%	36.2%	35.4%	34.5%	34.0%
Gross margin	63.7%	63.2%	62.7%	63.8%	64.6%	65.5%	66.0%
SG&A	38.3%	38.1%	34.2%	32.5%	31.7%	30.7%	29.6%
R&D	13.2%	11.5%	9.6%	9.1%	8.8%	8.6%	8.6%
Operating margin	11.6%	13.1%	18.4%	21.9%	23.7%	25.8%	27.5%
EBIT margin	*11.7%*	*13.8%*	*19.0%*	*22.5%*	*24.4%*	*26.5%*	*28.1%*
D&A	*1.5%*	*2.9%*	*2.7%*	*3.4%*	*2.9%*	*2.6%*	*2.3%*
EBITDA margin	*13.2%*	*16.7%*	*21.8%*	*25.8%*	*27.3%*	*29.1%*	*30.5%*
Pretax margin	10.7%	12.8%	18.2%	21.8%	21.9%	24.1%	25.9%
Net margin	6.8%	7.7%	11.9%	14.3%	15.5%	17.1%	18.4%

Source: Company Data, Morgan Stanley Research

Exhibit 25

Income Statement (2 of 2)

YOY % Change	2009A	2010A	2011A	2012E	2013E	2014E	2015E
Net revenues		30%	18%	3%	4%	7%	6%
COGS		32%	20%	0%	2%	5%	4%
Gross profit		29%	17%	5%	6%	9%	7%
SG&A		29%	6%	-2%	2%	4%	2%
R&D		13%	-1%	-3%	2%	5%	5%
Operating income		47%	65%	22%	13%	17%	13%
EBIT		*54%*	*62%*	*21%*	*14%*	*16%*	*12%*
EBITDA		*65%*	*54%*	*22%*	*10%*	*14%*	*11%*
Pretax income		55%	68%	23%	5%	18%	14%
Net income (Non-GAAP)		46%	83%	24%	13%	18%	14%
DILUTED EPS, proforma		46%	83%	24%	13%	18%	13%
Diluted shares outstanding		0%	0%	0%	0.3%	0.5%	0.5%
Basic shares outstanding		0%	0%	0%	0.0%	0.5%	0.5%

Source: Company Data, Morgan Stanley Research

Exhibit 26

Quarterly Income Statement

($M)	1Q:12A	2Q:12A	3Q:12A	4Q:12E	2012E	1Q:13E	2Q:13E	3Q:13E	4Q:13E	2013E
Net revenues	1,047	1,094	1,018	1,192	4,351	1,076	1,141	1,092	1,236	4,544
COGS	388	382	352	453	1,575	387	411	382	426	1,607
Gross profit	659	712	666	739	2,776	689	730	709	810	2,938
R&D	93	91	94	118	396	96	96	99	112	402
SG&A	331	351	330	400	1,412	338	351	337	416	1,441
Operating income	231	267	238	215	951	251	280	270	277	1,079
Other expense (income)	*6*	*7*	*10*	*3*	*26*	*8*	*8*	*8*	*8*	*32*
*Adjusted EBIT**	*237*	*274*	*248*	*218*	*977*	*259*	*288*	*278*	*285*	*1,111*
Depreciation	*19*	*33*	*41*	*37*	*130*	*29*	*29*	*29*	*29*	*115*
EBITDA	260	310	293	261	1,124	292	320	311	318	1,242
Other expenses/(income)	2	1	(3)	4	4	21	21	21	21	85
Interest expense	8	8	7	7	30	29	29	29	29	117
Other expense (income)	(6)	(7)	(10)	(3)	(26)	(8)	(8)	(8)	(8)	(32)
Pretax income	229	266	241	211	947	230	258	249	256	993
Taxes	76	90	89	70	325	67	75	72	74	288
Tax Rate	33.2%	33.8%	36.9%	33.0%	34.3%	29.0%	29.0%	29.0%	29.0%	29.0%
Net income (Non-GAAP)	152	176	153	141	623	163	183	177	182	705
DILUTED EPS, proforma	$0.30	$0.35	$0.31	$0.28	$1.25	$0.33	$0.37	$0.35	$0.36	$1.41
Diluted shares outstanding	500	500	500	500	500	502	502	502	502	502

Margin Analysis	1Q:12A	2Q:12A	3Q:12A	4Q:12E	2012E	1Q:13E	2Q:13E	3Q:13E	4Q:13E	2013E
COGS	37.1%	34.9%	34.6%	38.0%	36.2%	36.0%	36.0%	35.0%	34.5%	35.4%
Gross margin	62.9%	65.1%	65.4%	62.0%	63.8%	64.0%	64.0%	65.0%	65.5%	64.6%
R&D	8.9%	8.3%	9.2%	9.9%	9.1%	8.9%	8.4%	9.0%	9.1%	8.8%
SG&A	31.6%	32.1%	32.4%	33.6%	32.5%	31.4%	30.8%	30.8%	33.7%	31.7%
Operating margin	22.1%	24.4%	23.4%	18.0%	21.9%	23.3%	24.5%	24.8%	22.4%	23.7%
EBIT margin	22.6%	25.0%	24.4%	18.3%	22.5%	24.1%	25.2%	25.5%	23.1%	24.4%
EBITDA margin	*24.8%*	*28.3%*	*28.8%*	*21.9%*	*25.8%*	*27.1%*	*28.1%*	*28.5%*	*25.7%*	*27.3%*
Pretax margin	21.9%	24.3%	23.7%	17.7%	21.8%	21.4%	22.6%	22.8%	20.7%	21.9%
Pretax margin	21.9%	24.3%	23.7%	17.7%	21.8%	21.4%	22.6%	22.8%	20.7%	21.9%
Net margin	14.5%	16.1%	15.1%	11.9%	14.3%	15.2%	16.1%	16.2%	14.7%	15.5%

YOY % Change	1Q:12A	2Q:12A	3Q:12A	4Q:12E	2012E	1Q:13E	2Q:13E	3Q:13E	4Q:13E	2013E
Net revenues	6%	2%	-3%	6%	3%	3%	4%	7%	4%	4%
COGS	5%	-11%	-10%	14%	0%	0%	8%	9%	-6%	2%
Gross profit	7%	10%	1%	1%	5%	4%	3%	6%	10%	6%
R&D	-6%	-9%	-4%	7%	-3%	3%	5%	5%	-5%	2%
SG&A	-1%	-2%	0%	-6%	-2%	2%	0%	2%	4%	2%
Operating income	31%	46%	5%	12%	22%	9%	5%	13%	29%	13%
EBIT	29%	47%	6%	8%	21%	9%	5%	12%	31%	14%
EBITDA	*20%*	*44%*	*8%*	*20%*	*22%*	*12%*	*3%*	*6%*	*22%*	*10%*
Pretax income	31%	50%	7%	10%	23%	0%	-3%	3%	22%	5%
Net income (Non-GAAP)	25%	55%	5%	16%	24%	7%	4%	15%	29%	13%
DILUTED EPS, proforma	26%	55%	5%	16%	24%	7%	4%	15%	28%	13%
Diluted shares outstanding	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Source: Company Data, Morgan Stanley Research

Exhibit 27

Annual Revenue (1 of 2)

($M)	2010A	2011A	2012E	2013E	2014E	2015E
Total Revenue	3,582	4,233	4,351	4,544	4,882	5,164
Base revenue	2,968	3,821	4,456	4,544	4,882	5,164
Fx impact	69	104	(141)	-	-	-
Acquisitions	640	329	37	-	-	-
Divestitures	(95)	(21)	-	-	-	-
United States (U.S.)	1,384	1,659	1,765	1,802	1,946	2,043
Base revenue	1,250	1,473	1,751	1,802	1,946	2,043
Acquisitions	147	186	14	-	-	-
Divestitures	(13)	-	-	-	-	-
Europe/Africa/Middle East (EuAfME)	1,020	1,144	1,095	1,124	1,180	1,215
Base revenue	871	1,051	1,162	1,124	1,180	1,215
Fx impact	(6)	34	(75)	-	-	-
Acquisitions	229	59	8	-	-	-
Divestitures	(74)	-	-	-	-	-
Canada/Latin America (CLAR)	664	788	789	846	914	987
Base revenue	474	720	840	846	914	987
Fx impact	44	28	(58)	-	-	-
Acquisitions	146	49	7	-	-	-
Divestitures	-	(9)	-	-	-	-
Asia Pacific (APAC)	514	642	703	773	842	918
Base revenue	373	577	703	773	842	918
Fx impact	31	42	(9)	-	-	-
Acquisitions	118	35	8	-	-	-
Divestitures	(8)	(12)	-	-	-	-

Source: Company Data, Morgan Stanley Research

Exhibit 28

Annual Revenue (2 of 2)

YOY % CHANGE	2010A	2011A	2012E	2013E	2014E	2015E
Total Revenue	30%	18%	3%	4%	7%	6%
Base growth	8%	7%	5%	4%	7%	6%
Fx impact	3%	3%	-3%	NM	NM	NM
Acquisitions	23%	9%	1%	NM	NM	NM
Divestitures	-3%	-1%	0%	NM	NM	NM
United States (U.S.)	25%	20%	6%	2%	8%	5%
Base growth	13%	6%	6%	2%	8%	5%
Acquisitions	13%	13%	1%	NM	NM	NM
Divestitures	-1%	0%	0%	NM	NM	NM
Europe/Africa/Middle East (EuAfME)	16%	12%	-4%	3%	5%	3%
Base growth	-1%	3%	2%	3%	5%	3%
Fx impact	-1%	3%	-7%	NM	0%	0%
Acquisitions	26%	6%	1%	NM	NM	NM
Divestitures	-8%	0%	0%	NM	NM	NM
Canada/Latin America (CLAR)	47%	19%	0%	7%	8%	8%
Base growth	5%	8%	7%	7%	8%	8%
Fx impact	10%	4%	-7%	NM	0%	0%
Acquisitions	32%	7%	1%	NM	NM	NM
Divestitures	0%	-1%	0%	NM	NM	NM
Asia Pacific (APAC)	59%	25%	9%	10%	9%	9%
Base growth	15%	12%	10%	10%	9%	9%
Fx impact	10%	8%	-1%	NM	0%	0%
Acquisitions	36%	7%	1%	NM	NM	NM
Divestitures	-2%	-2%	0%	NM	NM	NM

Source: Company Data, Morgan Stanley Research

Exhibit 29
Historical and Projected Revenues by Species

Revenue by Species ($M)	2010A	2011A	2012E	2013E	2014E	2015E
Livestock	2,233	2,778	2,730	2,723	2,978	3,150
Cattle	1,464	1,617				
Swine	433	562				
Poultry	265	501				
Other (Fish and Sheep)	71	98				
Companion Animal	1,349	1,455	1,621	1,821	1,904	2,014
Horses	159	168				
Dogs and Cats	1,190	1,287				

YOY % CHANGE	2010A	2011A	2012E	2013E	2014E	2015E
Livestock	32%	24%	-2%	0%	9%	6%
Cattle	30%	10%	NM			
Swine	12%	30%	NM			
Poultry	112%	89%	NM			
Other (Fish and Sheep)	51%	38%	NM			
Companion Animal	26%	8%	11%	12%	5%	6%
Horses	99%	6%	NM			
Dogs and Cats	20%	8%	NM			

Source: Company Data, Morgan Stanley Research

Exhibit 30
Segment Revenue Breakdown

% of total revenue	2010A	2011A	2012E	2013E	2014E	2015E
United States (U.S.)	39%	39%	41%	40%	40%	40%
Europe/Africa/Middle East (EuAfME)	28%	27%	25%	25%	24%	24%
Canada/Latin America (CLAR)	19%	19%	18%	19%	19%	19%
Asia Pacific (APAC)	14%	15%	16%	17%	17%	18%
Livestock	62.3%	65.6%	62.7%	59.9%	61.0%	61.0%
Companion Animal	37.7%	34.4%	37.3%	40.1%	39.0%	39.0%

Source: Company Data, Morgan Stanley Research

Exhibit 31

Quarterly Revenue

($M)	1Q:12A	2Q:12A	3Q:12A	4Q:12E	2012E	1Q:13E	2Q:13E	3Q:13E	4Q:13E	2013E
Total Revenue	1,047	1,094	1,018	1,192	4,351	1,076	1,141	1,092	1,236	4,544
Base revenue	1,024	1,137	1,081	1,214	4,456	1,076	1,141	1,092	1,236	4,544
Fx impact	(14)	(43)	(63)	(22)	(141)	-	-	-	-	-
United States (U.S.)	425	420	448	471	1,765	417	420	479	486	1,802
Base revenue	412	420	448	471	1,751	417	420	479	486	1,802
Europe/Africa/Middle East (EuAfME)	275	283	241	296	1,095	278	292	253	302	1,124
Base revenue	277	305	272	308	1,162	278	292	253	302	1,124
Fx impact	(10)	(22)	(31)	(12)	(75)	-	-	-	-	-
Canada/Latin America (CLAR)	173	211	165	240	789	190	228	178	249	846
Base revenue	172	230	188	250	840	190	228	178	249	846
Fx impact	(6)	(19)	(23)	(10)	(58)	-	-	-	-	-
Asia Pacific (APAC)	174	179	165	185	703	191	201	181	199	773
Base revenue	164	182	173	185	703	191	201	181	199	773
Fx impact	2	(2)	(8)	-	(9)	-	-	-	-	-
YOY % CHANGE	1Q:12A	2Q:12A	3Q:12A	4Q:12E	2012E	1Q:13E	2Q:13E	3Q:13E	4Q:13E	2013E
Total Revenue	6%	2%	-3%	6%	3%	3%	4%	7%	4%	4%
Base growth	4%	6%	3%	8%	5%	3%	4%	7%	4%	4%
Fx impact	-1%	-4%	-6%	-2%	-3%	0%	0%	0%	0%	NM
United States (U.S.)	12%	7%	2%	5%	6%	-2%	0%	7%	3%	2%
Base growth	8%	7%	2%	5%	6%	-2%	0%	7%	3%	2%
Europe/Africa/Middle East (EuAfME)	-2%	-4%	-12%	1%	-4%	1%	3%	5%	2%	3%
Base growth	-2%	3%	0%	5%	2%	1%	3%	5%	2%	3%
Fx impact	-3%	-7%	-12%	-4%	-7%	0%	0%	0%	0%	NM
Canada/Latin America (CLAR)	2%	-2%	-8%	8%	0%	10%	8%	8%	4%	7%
Base growth	2%	6%	4%	12%	7%	10%	8%	8%	4%	7%
Fx impact	-4%	-9%	-13%	-4%	-7%	0%	0%	0%	0%	NM
Asia Pacific (APAC)	15%	5%	4%	14%	9%	10%	12%	10%	8%	10%
Base growth	8%	6%	9%	14%	10%	10%	12%	10%	8%	10%
Fx impact	1%	-1%	-5%	0%	-1%	0%	0%	0%	0%	NM
Livestock	66.0%	60.8%	64.7%	60.0%	62.7%	59.0%	59.0%	60.0%	61.5%	59.9%
Companion Animal	34.0%	39.2%	35.3%	40.0%	37.3%	41.0%	41.0%	40.0%	38.5%	40.1%

Source: Company Data, Morgan Stanley Research

Exhibit 32

Cash flow statement

($M)	2010A	2011A	2012E	2013E	2014E	2015E
Net income (Non-GAAP)	275	503	623	705	834	948
GAAP adjustments	(164)	(255)	(60)	(175)	(100)	(75)
Net income before minority interest (GAAP)	111	248	563	530	734	873
Depreciation & amortization	185	205	196	185	180	175
Depreciation	86	95	130	115	110	105
Amortization	99	110	66	70	70	70
Change in operating assets and liabilities	100	(117)	(543)	(87)	(79)	(94)
Other operating activities	(142)	161	(57)	-	-	-
Net cash from operating activities	254	497	159	628	835	954
Purchase of PP&E	(124)	(135)	(140)	(170)	(170)	(120)
Other investing activities	115	(314)	(10)	-	-	-
Net cash from investing activities	(9)	(449)	(150)	(170)	(170)	(120)
Cash dividends paid	(207)	(416)	(3,410)	(130)	(150)	(174)
Net change in short-term debt	-	-	-	-	-	-
Net change in long-term debt	-	(143)	3,650	-	-	(400)
Acquisitions, share repurchases, other	(70)	529	-	-	-	-
Net cash from financing activities	(277)	(30)	240	(130)	(150)	(574)
Effect of exchange rates	(4)	(2)	-	-	-	-
Net increase in cash	(36)	16	249	328	515	261
Cash at beginning of period	99	63	79	328	656	1,171
Cash at end of period	63	79	328	656	1,171	1,432

Source: Company Data, Morgan Stanley Research

Exhibit 33

Balance Sheet

($M)	2010A	2011A	2012E	2013E	2014E	2015E
Cash and short-term investments	63	79	328	656	1,171	1,432
Receivables	773	871	961	952	1,103	1,071
Inventories	995	1,063	1,457	1,464	1,403	1,464
Other current assets	285	298	300	325	350	400
Current assets	2,116	2,311	3,046	3,398	4,027	4,367
Net property, plant and equipment	1,148	1,243	1,253	1,308	1,368	1,383
Other assets	2,020	2,157	2,101	2,031	1,961	1,891
Total Assets	5,284	5,711	6,400	6,737	7,356	7,641
Short-term debt	38	-	-	-	-	-
Accounts Payable	206	214	236	223	258	243
Other current liabilities	564	629	550	500	500	500
Current liabilities	808	843	786	723	758	743
Long-term debt	673	575	3,650	3,650	3,650	3,250
Other liabilities	459	557	500	500	500	500
Total Liabilities	1,940	1,975	4,936	4,873	4,908	4,493
Preferred stock			-	-	-	-
Common Equity	3,344	3,720	1,448	1,848	2,432	3,131
Minority Interest	-	16	16	16	16	16
Shareholders' Equity	3,344	3,736	1,464	1,864	2,448	3,147
Total Liabilities and SE	5,284	5,711	6,400	6,737	7,356	7,641

Source: Company Data, Morgan Stanley Research

Exhibit 34

Capital Structure

	2010A	2011A	2012E	2013E	2014E	2015E
Capital structure						
Net debt	648	496	3,322	2,994	2,479	1,818
Net debt-to-equity	0.2	0.1	2.3	1.6	1.0	0.6
Net Debt to Capital	16.0%	11.5%	65.0%	54.3%	40.6%	28.4%
Total Debt	711	575	3,650	3,650	3,650	3,250
Total Debt to Capital	17.5%	13.3%	71.4%	66.2%	59.9%	50.8%
Total Debt to EBITDA (current year)	1.2x	0.6x	3.2x	2.9x	2.6x	2.1x
Net Debt to EBITDA (current year)	1.1x	0.5x	3.0x	2.4x	1.7x	1.2x
Interest coverage ratio	(13)	(22)	(33)	(9)	(11)	(12)
Interest expense	(37)	(36)	(30)	(117)	(119)	(117)
Dividend payout ratio	75%	83%	548%	18%	18%	18%
Dividend per share	$0.41	$0.83	NM	$0.26	$0.30	$0.34
Dividend growth	105%	101%	NM	NM	15%	15%

Source: Company Data, Morgan Stanley Research

Exhibit 35

Financial Metrics

($M)	2010A	2011A	2012E	2013E	2014E	2015E
Operating efficiency						
Accounts receivable turnover	4.6x	5.1x	4.75x	4.75x	4.75x	4.75x
Inventory turnover	1.3x	1.5x	1.3x	1.1x	1.2x	1.2x
Accounts payable turnover	6.4x	7.5x	7.0x	7.0x	7.0x	7.0x
Fixed asset turnover	3.1x	3.5x	3.5x	3.5x	3.6x	3.8x
Depreciation to fixed assets ratio		0.08x	0.10x	0.09x	0.08x	0.08x
Days sales outstanding	79	71	77	77	77	77
Days payables outstanding	57	48	52	52	52	52
Days inventory held	276	238	292	332	311	298
Cash conversion cycle (days)	297	260	317	357	335	323
Liquidity						
Working capital	1,308	1,468	2,260	2,675	3,269	3,623
Current ratio	2.6	2.7	3.9	4.7	5.3	5.9
Quick ratio	1.4	1.5	2.0	2.7	3.5	3.9
Cash ratio	0.1	0.1	0.4	0.9	1.5	1.9
Profitability						
Adjusted EPS	$0.55	$1.01	$1.25	$1.41	$1.65	$1.87
GAAP EPS	$0.22	$0.50	$1.13	$1.06	$1.46	$1.72
GAAP vs adjusted	($0.33)	($0.51)	($0.12)	($0.35)	($0.20)	($0.15)
Adjusted EBIT*	$496	$806	$977	$1,111	$1,294	$1,453
Adjusted EBITDA	$599	$921	$1,124	$1,242	$1,419	$1,573
Operating cash flow per share	$0.94	$1.43	$1.64	$1.90	$2.13	$2.34
FCF per share	$0.11	$0.56	($0.05)	$0.94	$1.35	$1.67
OCF	468	716	821	951	1,076	1,184
FCF	54	279	(27)	472	680	848
FCF less dividends	(153)	(137)	(3,437)	342	529	674
FCF less dividends/share buybacks	(156)	(137)	(3,437)	342	529	674
Book value per share	$6.69	$7.47	$2.93	$3.72	$4.86	$6.21
Return on asset/equity						
EBT margin	12.8%	18.2%	21.8%	21.9%	24.1%	25.9%
ROA	24.0%	42.1%	49.9%	55.1%	62.3%	68.9%
Leverage (assets/equity)	1.6	1.6	2.3	3.9	3.3	2.7
Tax effect	60.1%	65.7%	65.7%	71.0%	71.0%	71.0%
ROE	8.2%	13.5%	42.5%	37.8%	34.1%	30.1%
ROIC				14.3%	16.5%	18.5%
NOPAT				766	896	1,009
Invested Capital (Assets- Cash- Current Liabilities)				5,358	5,427	5,465

Source: Company data, Morgan Stanley Research estimates

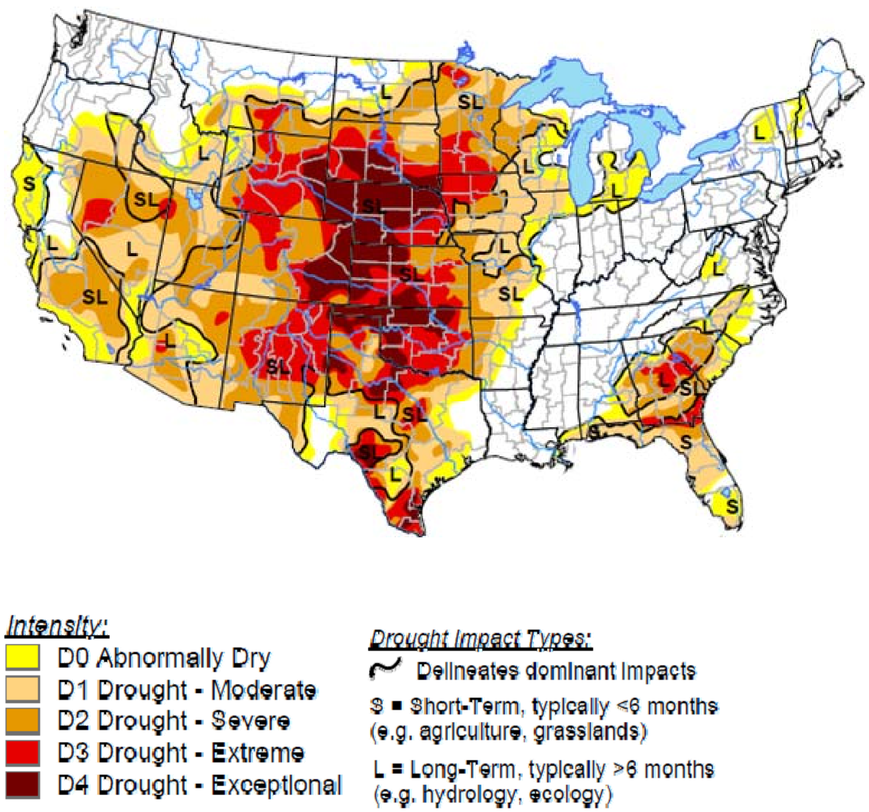
Appendix

Drought Mini-Primer Slideshow for Healthcare Investors

Drought may negatively impact sales of livestock animal health products

- Worst drought in over 100 years
- U.S. cattle (est. 14% of global revenues) are the primary species affected
  - Drought negatively impacts availability of grazing pasture and supply of corn
- In the wake of lower production volumes and declining margins, some may question whether farmers will squeeze animal health manufacturers to bolster profitability
  - Farmers are faced with lower production volumes, higher input costs (e.g., corn), and market prices that are not keeping up with costs
- U.S. poultry and hogs are being impacted to a lesser extent
- In Latin America, drought is primarily impacting cattle production in Northern Mexico (Brazil is not significantly impacted)
  - But higher global feed costs could pressure poultry and swine throughout the region
- Higher feed costs could pressure livestock in Canada

U.S. Drought Monitor (as of 2/19/13)



Source: Richard Heim, NOAA/ NESDIS/ NCDC
http://droughtmonitor.unl.edu

U.S. feeder cattle are down 6% YOY, but we expect a rebound in 2H:13 and 2014

Feeder cattle are a good indicator of cattle pharma/ vaccine trends

- Use of anti-infectives, respiratory vaccines and feed additives increase with the movement of livestock from pasture to feedlots in the fall
- Feeder cattle peak in Nov. and trough in Jul.

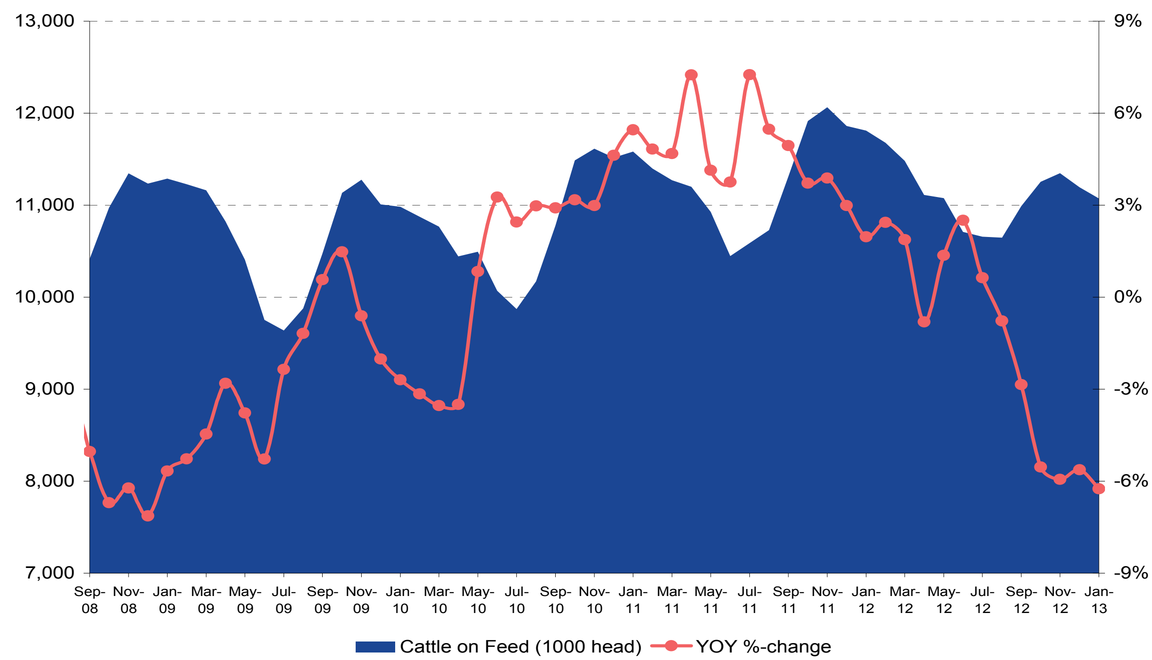
Feeder cattle YOY growth slowed from +3% in July to -6% in Dec.

- Reduced availability of grazing pasture may have forced some cattle producers to advance herds into feedlots earlier; this is consistent with an incr. in feeder cattle placements in 3Q
- However, as the drought persists, fewer heads of cattle have resulted in declining feedlot placements in 4Q

Comps ease in 2H:13

- But volumes may remain challenged if unprecedented drought persists
- Production declines in could drive higher meat prices in ’13-beyond and cause farmers to ramp production in 2014
- We project total co. rev. growth to accelerate from +4% in ‘13E to +7% in ‘14E

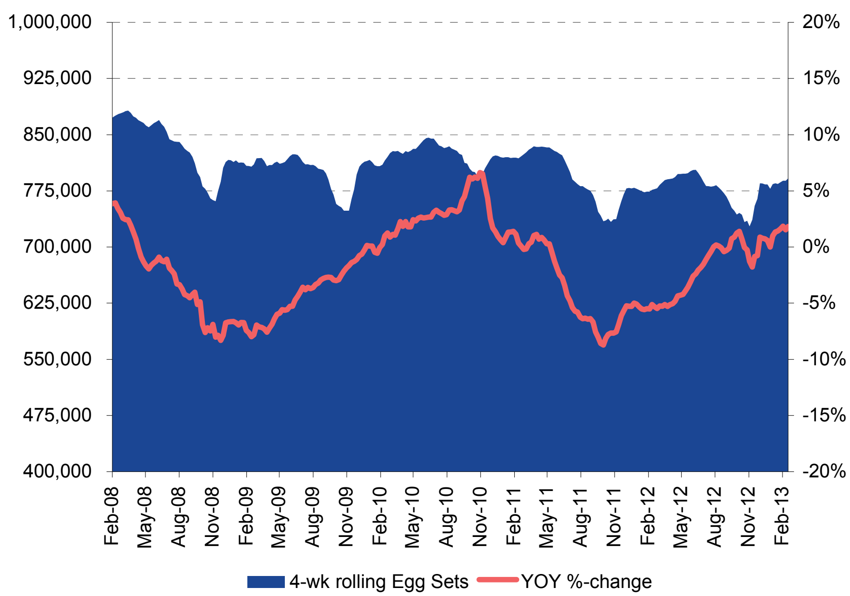
Number of Cattle on Feed on 1,000+ Capacity Feedlots



Source: USDA, National Agricultural Statistics Service, Morgan Stanley Equity Research

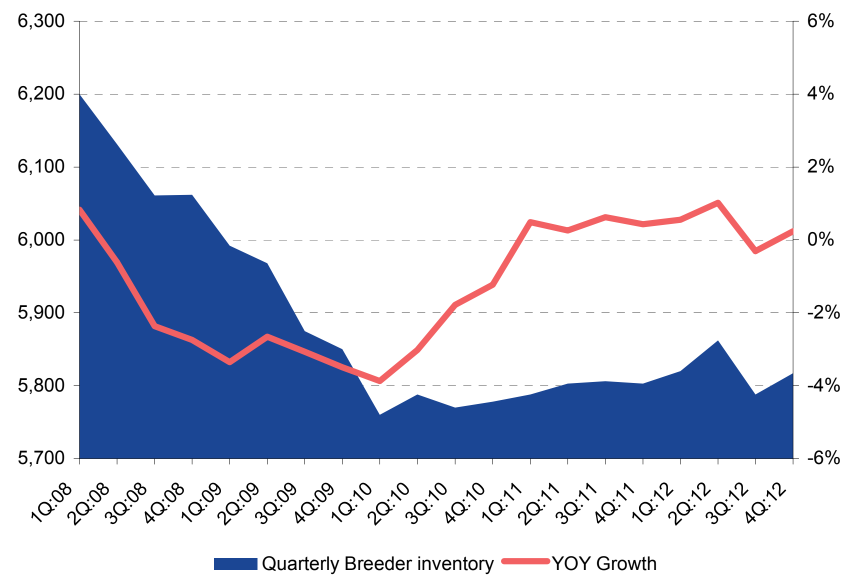
Drought appears to impact U.S. poultry and hogs to a lesser extent

Chicken eggs set in incubators are good indicator of future demand for Zoetis products; recent trends do not suggest outsized drought risk



Source: USDA, National Agricultural Statistics Service (NASS), Morgan Stanley Equity Research

Hog breeder inventory (pregnant pigs that are giving birth) are good indicator of future demand for Zoetis products; breeder inventories appear to have bottomed and not face significant drought risk



Source: USDA, Morgan Stanley Equity Research

We view the drought as a manageable near-term risk; long-term fundamentals strong

The drought impacts a modest percentage of Zoetis' portfolio

- U.S. cattle, the primary species being affected, accounted for 14% of 2011A global revenues
- U.S. poultry and pigs (7% of global revenues) are being impacted to a lesser extent (primary impact of drought is on feed costs, but recent production trends have been stable)
- In LatAm, the drought is primarily impacting cattle in Mexico (est. 1-2% of global revs.); cattle in Brazil (est. 3-5% of global revs.) are primarily grass fed and major pasturelands are not experiencing the drought
- However, higher global feed prices could constrain other livestock production

Farmers continue to invest in high-quality vaccines to protect/ preserve their assets

- Animal Health products account for 2-3% of the total costs of meat production
- Farmers are loyal to vaccines (could mean the difference between life and death for calves)
  - Economic outcomes studies have driven increased demand for premium anti-infectives in cattle & swine
- However, our expert noted risk that farmers could cut back parasiticides (not a life or death proposition)

We estimate a 1-2% ($45-$90M) top-line risk in 2013

- Assuming U.S. feeder cattle inventories are down 5-10% in '13E (vs. down 6% YOY in Dec.), we est. a $30-$60M headwind.
- Assuming Mexico cattle inventories decline 7-12% in '13E (USDA projects ending cattle inventories down 8% YOY in 2013E), we estimate a $3-5M headwind
- Assuming higher global feed costs are a 2-3% headwind on other U.S., Canada, and LatAm livestock (ex-Brazil cattle), we estimate a $15-$20M headwind

MORGAN STANLEY ModelWare	**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of February 28, 2013)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1025**	**36%**	**394**	**39%**	**38%**
Equal-weight/Hold	**1242**	**44%**	**477**	**47%**	**38%**
Not-Rated/Hold	**104**	**4%**	**26**	**3%**	**25%**
Underweight/Sell	**474**	**17%**	**114**	**11%**	**24%**
Total	**2,845**		**1011**		

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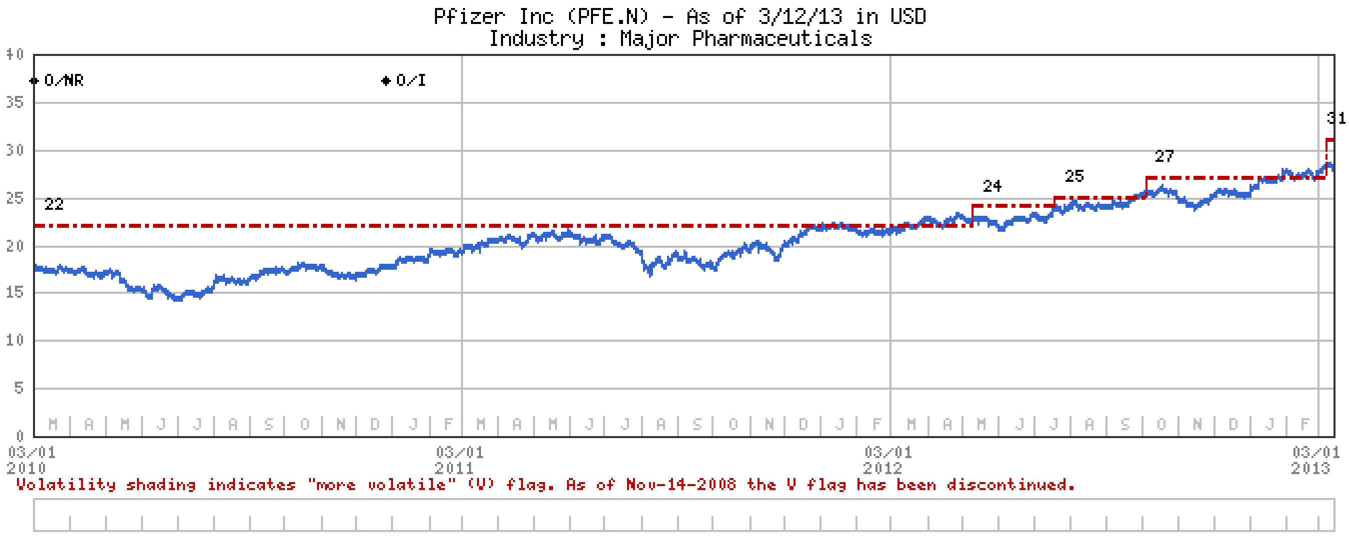
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 3/1/10 : O/NR; 12/26/10 : O/I

Price Target History: 2/1/10 : 22; 5/9/12 : 24; 7/18/12 : 25; 10/4/12 : 27; 3/7/13 : 31

Source: Morgan Stanley Research   Date Format : MM/DD/YY   Price Target -·   No Price Target Assigned (NA)

Stock Price (Not Covered by Current Analyst)   Stock Price (Covered by Current Analyst)

Stock and Industry Ratings (abbreviations below) appear as ◆ Stock Rating/Industry View

Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)

Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Industry Coverage:Specialty Pharmaceuticals

Company (Ticker)	Rating (as of)	Price* (03/12/2013)
David Risinger		
Zoetis Inc. (ZTS.N)	E (03/13/2013)	$33.82
Actavis Inc (ACT.N)	O (01/25/2012)	$90.1
Alkermes Plc. (ALKS.O)	O (01/10/2013)	$22.96
Allergan Inc. (AGN.N)	O (09/07/2010)	$110.08
Forest Laboratories Inc. (FRX.N)	E (04/26/2011)	$38.04
Mylan Inc. (MYL.O)	E (03/01/2013)	$30.95
Perrigo Co. (PRGO.O)	O (02/04/2013)	$117.6
Teva Pharmaceutical Industries Ltd. (TEVA.N)	E (02/06/2012)	$40.53
Valeant Pharmaceuticals International (VRX.N)	E (09/14/2012)	$70.6
Warner Chilcott Plc (WCRX.O)	U (08/21/2012)	$13.46
Marshall Urist, M.D., Ph.D.		
Hospira (HSP.N)	E (07/16/2009)	$31
Sagent Pharmaceuticals Inc (SGNT.O)	E (08/13/2012)	$17.36

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