Zoetis, Inc.

(ZTS - $31.63)

November 5, 2013

Company Update | Note

Medical Devices & Supplies

Strong Buy
$41.00

Trading Data:

Last Price (11/05/2013)	$31.63
52–Week High (3/14/2013)	$35.42
52–Week Low (8/28/2013)	$28.81
Market Cap. (MM)	$15,815
Shares Out. (MM)	500
3 Month Avg. Daily Vol. (MM)	4.216

Estimates/TP Changes

Item	FY	Previous	Current
EPS ($)	FY15E	N/A	$1.75
	FY14E	$1.55	$1.57
	FY13E	$1.38	$1.40

Earnings Estimates: ($ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY15E	0.44	0.45	0.43	0.43	1.75
FY14E	0.39	0.41	0.39	0.38	1.57
FY13E	0.36A	0.36A	0.34A	0.34	1.40
FY12A	0.30	0.35	0.30	0.12	1.08

Valuation:

Multiple	Curr. FY	Next FY	Next FY @ PT
P/E	20.2	18.1	23.5
EV / EBITDA	13.3	11.8	14.9
EV / Revs.	3.8	3.5	4.4

Source: CL King & Associates estimates

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See required disclosures at the end of report.

View Q3 Results Positively; Stock Offers Attractive Risk-Reward

- Zoetis reported strong Q3 results, driven by strong organic revenue growth of 9%, which was much higher than our estimate of 4.8%. Revenue performance across all regions and species was very good, in our view. The company's organic revenue growth in Q3 was meaningfully higher than the industry's, based on our computations.

- In our opinion, the quarter results suggest the company's business is performing very well. We believe the current price of about $32 represents a very attractive risk-reward, and we reiterate our Strong Buy rating.

- We are raising our 2013 and 2014 EPS estimates slightly to $1.40 and $1.57 from $1.38, and $1.55, respectively. We are introducing our 2015 EPS estimate of $1.75.

- Some analysts seemed bothered by the SG&A margin in Q3, but we are not concerned as the company's 2013 SG&A expense guidance has not changed meaningfully. More importantly, we believe organic revenue growth will be a key driver of Zoetis' longer-term margin expansion; the company's Q3 revenue growth increased our confidence in our revenue projections.

We view Zoetis' Q3 results very favorably and we believe the stock is very attractive at the current price of about $32: We view Zoetis' Q3 (September) results as strong; however, we are surprised investors did not push the stock a little higher following the results. The Q3 results were driven by excellent organic revenue growth of 9%, which was well above our estimate of 4.8%. Revenue performance in all the regions and across all species was very good, in our view. Based on our computations, the company's organic revenue growth is outperforming the industry by a meaningful margin.

Summary of Q3 revenues and EPS: Zoetis reported Q3 revenues of $1,103MM compared to $1,019MM last year; our revenue estimate was $1,082MM and the consensus was $1,061MM. Reported Q3 adjusted EPS were $0.34 compared to $0.31 last year; the result was slightly higher than our estimate of $0.33 and equal to the consensus EPS estimate of $0.34.

Margins were very good: We view the quality of the EPS result as very good. The gross profit margin was 65.3% compared to 65.5% last year and our estimate of 65.0%. Some contract manufacturing business may have hindered the gross profit margin compared to last year. Reported SG&A as a percentage of revenues was 32.5% compared to 32.4% and our estimate of 32.4%. R&D was 8.3% of revenues compared to 9.2% last year and our estimate of 9.2%.

Some analysts seem bothered by the Q3 SG&A margin, but we are not concerned: During the company's conference call some analysts seemed to be disappointed in the SG&A expense result, but we are not. The midpoint of Zoetis' new 2013 SG&A expense guidance range of $1,405MM-1,425MM is $1,415MM, which is equivalent to the $1,410MM midpoint of its previous SG&A expense guidance range of $1,385MM-$1,435MM. We conservatively assume SG&A expense of $1,432MM in our financial model.

Organic revenue growth should drive margin expansion: More importantly, we continue to believe Zoetis should be able to achieve meaningful expansion in its operating profit margin over the next several years as long as organic revenue growth is at least 5%-6% annually. Related to this, the company's strong organic revenue growth in Q3 combined with recent new product approvals increases our confidence in our revenue growth projections for the balance of 2013 and for all of 2014 and 2015. We are projecting organic revenue growth of about 4.5% in 4Q13 and 5.6% for all of 2013. We are projecting organic revenue growth of approximately 7% in 2014 and approximately 6% in 2015.

Raising our EPS estimates slightly: We are raising our 2013 EPS estimate to $1.40 from $1.38 and raising our 2014 EPS estimate to $1.57 from $1.55. In addition, we are establishing our 2015 EPS estimate of $1.75. The increase in our 2013 EPS estimate is the result of the one penny higher EPS result in Q3 compared to our projection and a slight increase in our operating profit margin assumption for Q4. The increase in our 2014 EPS estimate is the result of a slight increase in our operating profit forecast, as we are more confident in our 2014 revenue growth projection, as we discussed previously.

Zoetis raised the low end of its 2013 guidance: Zoetis raised the low end of its revenue and EPS guidance for 2013. Revenue is now projected in a range of $4,475MM-$4,525MM, up from $4,425MM-$4,525MM. The new adjusted EPS guidance is $1.38-$1.42, up from $1.36-$1.42.

The company's new revenue guidance seems a little conservative to us given the strength of the Q3 results. We are maintaining our full-year 2013 revenue estimate of $4,525MM. Our 4Q13 revenue projection assumes organic revenue growth of about 4.5% and approximately a 1% negative impact from foreign currencies.

Growth trends for Zoetis and the industry

For perspective, we show recent growth trends for Zoetis and the animal pharmaceutical industry in Chart 1 below. While Zoetis showed strong acceleration in its organic revenues in Q3, we do not growth will continue at this pace. Importantly, based on our computations we estimate Zoetis is outperforming the industry by a meaningful margin.

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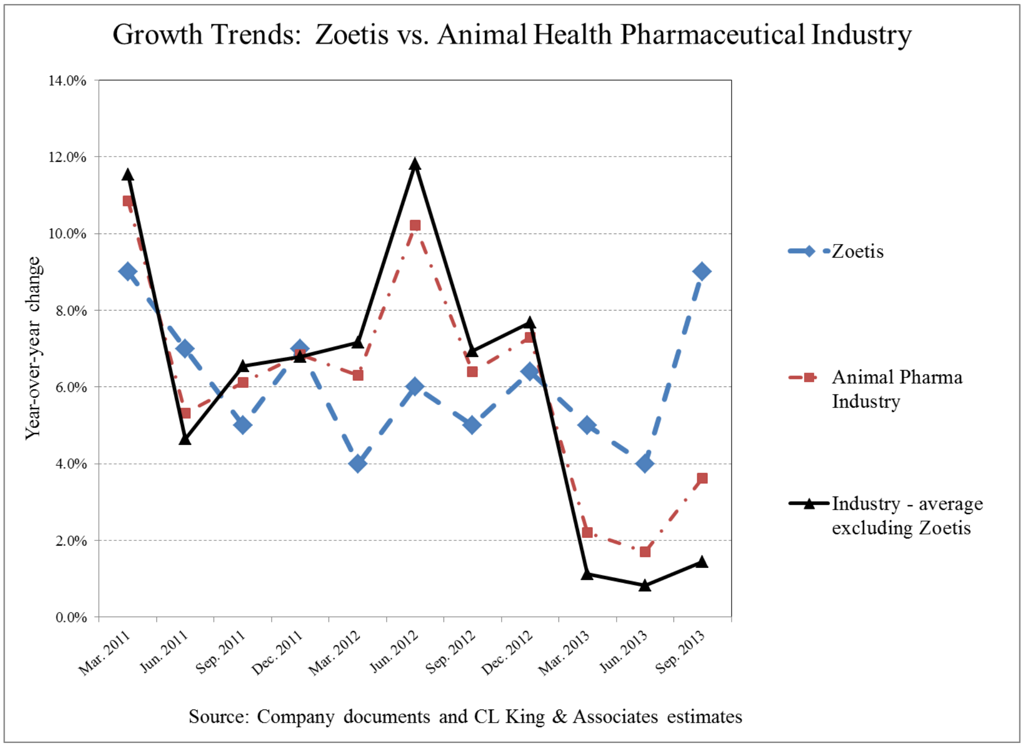
Zoetis' Q3 organic revenue growth of 9% compares very favorably to the growth rates of its major competitors.

Chart 1: Organic Growth Trends – Zoetis and the Animal Pharmaceutical Industry



Note: Our data in Chart 1 includes Bayer (BAYN-ET: NR), Eli Lilly (LLY: NR), Merck (MRK: NR), Vetoquinol (VETO-PA), Virbac (VIRB-PA), and Zoetis.
Source: Company documents and CL King & Associates estimates

Table 1: Zoetis Organic Revenue Growth by Region and Species

Item	Q1:13A	Q2:13A	Q3:13A
Revenue by region:			
United States:			
Livestock	2%	6%	11%
Companion animal	13%	2%	10%
Subtotal, United States	**7%**	**4%**	**10%**
Europe, Africa, Middle East:			
Livestock	3%	-2%	7%
Companion animal	6%	6%	15%
Subtotal, EuAfME	**4%**	**1%**	**9%**
Canada, Latin America, Russia:			
Livestock	6%	4%	6%
Companion animal	-5%	6%	19%
Subtotal, CLAR	**4%**	**4%**	**9%**
Asia/Pacific/China			
Livestock	3%	5%	8%
Companion animal	2%	13%	3%
Subtotal, APAC	**2%**	**7%**	**7%**
Total revenue:			
Livestock	3%	3%	8%
Companion animal	8%	5%	11%
Total	**5%**	**4%**	**9%**

Item	Q1:13A	Q2:13A	Q3:13A
Species:			
Livestock:			
Cattle	-2%	0%	7%
Swine	11%	9%	12%
Poultry	12%	9%	8%
Other	-3%	10%	5%
Subtotal, livestock	**3%**	**3%**	**8%**
Companion animal:			
Horses	-8%	-10%	5%
Dogs and cats	10%	7%	12%
Subtotal, companion animal	**8%**	**5%**	**11%**
Total	**5%**	**4%**	**9%**

Source: Company documents

Investment thesis and valuation

We believe Zoetis is well positioned to deliver stable, predictable and sustainable growth. We forecast the five-year compound annual growth in organic revenues and EPS should be at least 6% and 10%, respectively. Also, we view Zoetis as an excellent investment in the growth of the animal health industry. Zoetis has many of the characteristics of the other high-quality, growing animal health companies we follow. These include stable revenue growth, high margins and returns and operations within an oligopolistic animal health industry segment. We project the global animal pharmaceutical industry should grow 6% annually over the next five years, driven by both the production animal and companion animal sectors. We also believe growth in developing economies and increasing global demand for protein should be an important source of the company's long-term growth. Emerging markets now contribute 27% of Zoetis' revenues.

We believe in the current sluggish macroeconomic environment investors will continue to be attracted to companies like Zoetis that are able to deliver steady revenue and earnings growth driven by unit growth and pricing power adequate to offset cost inflation. Furthermore, we anticipate healthcare investors will continue to be attracted to companies that are insulated from reimbursement pressure from the government and other third parties. We believe Zoetis' industry-leading position and high market share should facilitate its growth and help mitigate risk. In addition, we believe the company's high level of R&D spending and large direct sales and marketing organization help create sustainable competitive advantages. Valuation data is in the table below.

Table 2: Valuation Multiples for Zoetis

Item	2012PF	2013E	2014E	2015E
Stock price	$31.63	$31.63	$31.63	$31.63
Revenues (in 1,000's)	$4,336,000	$4,524,650	$4,831,626	$5,134,203
EBITDA (in 1,000's)	$1,105,000	$1,299,832	$1,397,854	$1,523,271
EPS - GAAP	$1.01	$1.37	$1.48	$1.66
EPS adj to add back amortization exp.	**$1.08**	**$1.40**	**$1.57**	**$1.75**
P / E ratio - based on adj. EPS	**29.4 x**	**22.7 x**	**20.2 x**	**18.1 x**
EV / EBITDA ratio	**17.2 x**	**14.7 x**	**13.3 x**	**11.8 x**
EV / Revenue ratio	**4.4 x**	**4.2 x**	**3.8 x**	**3.5 x**
ROA	9.2%	11.8%	13.4%	14.9%
ROE	22.2%	63.5%	55.7%	42.1%
Enterprise value computation:				
Equity market value (in 1,000's)	$15,812,500	$15,898,558	$16,058,141	$16,219,326
Total debt (in 1,000's)	$3,640,000	$3,352,000	$2,552,000	$1,952,000
Cash (in 1,000's)	$484,000	$194,381	$52,248	$184,146
Enterprise value (in 1,000's)	$18,968,500	$19,056,178	$18,557,893	$17,987,180

Source: CL King & Associates estimates

Risks

There are a number of potential risks that could have a negative effect on Zoetis' business and its stock. Regulators could impose new restrictions on the use of antibiotics in production animals due to concerns about antimicrobial resistance in humans. Similarly, changes in consumer views of products from animals treated with antibiotics could also impact Zoetis' business. The production animal and companion animal markets are sensitive to the economy, so if the economy weakens materially Zoetis' revenues and income may be lower than we project. Furthermore, severe weather conditions such as drought could negatively affect Zoetis' production animal business. For example, drought can result in higher grain and feed prices and reduce available grazing pastures, either one of which could result in a reduction of beef and dairy cattle herds. Within our financial forecasts we project Zoetis' margins should expand over the next several years. There is a risk the company may not be successful in improving margins as much as we expect. Also, the company may not be as *effective as we project in managing its operations and expenses during its process of fully separating from Pfizer (PFE: NR).*

Previous research update – 08/06/13

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DISCLOSURES:

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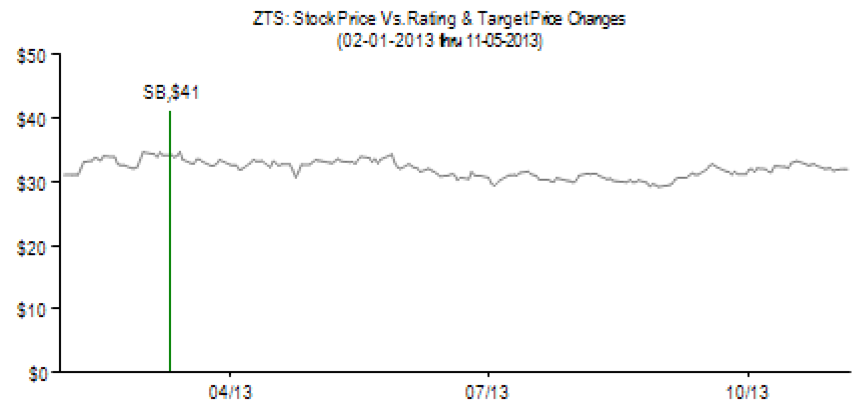
RATINGS INFORMATION

Rating and Price Target Change History



3 Year Rating Change History

Date	Rating	Closing Price ($)
03/11/2013	Strong Buy (SB)	34.18

3 Year Price Change History

Date	Target Price	Closing Price ($)
03/11/2013	41.00	34.18

Source: CL King & Associates, Created by: wwww.ResearchMaestro.net

Note: Prior to 02/01/2011 Buy was Accumulate
Prior to 02/01/2011 Sell was Underperform

CL King Rating System*		**% of Companies Under Coverage With This Rating**	**% of Companies for which CL King has performed services for in the last 12 months**	
			Investment Banking	**Brokerage**
Strong Buy (SB)	Analyst believes shares will appreciate by 20% or more over the next 6-12 months and should significantly outperform the broader market averages. Analyst believes the risk of long-term capital impairment is below-average.	16.51%	0.00%	1.83%
Buy (B)	Analyst believes shares will appreciate in a range of 10% to the upper teens over the next 6-12 months and will outperform the broader capital market averages. Analyst believes the risk of long-term capital impairment is below-average, but not as low as it is for Strong Buy.	36.70%	1.83%	0.00%
Neutral (N)	Analyst believes the current stock price fairly discounts the company's prospects over the next 6-12 months, give or take 10%, and will trade in-line with the broader market averages. Analyst believes the risk of permanent capital impairment is about average.	44.04%	1.83%	2.75%
Sell (S)	Analyst expects the stock price to decline 10% or more over the next 6-12 months and to underperform the broader market averages.	0.92%	0.00%	0.00%

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