Zoetis Inc ZTS (NYSE) | BBB+

Business Risk	Cash Flow Cushion™	Solvency Score	Distance To Default	Economic Moat™	Industry Group	Sector
Good	Good	Good	Very Good	Wide	Drug Manufacturers	Healthcare

Zoetis Posts In-Line 3Q Results

See Page 6 for the full Analyst Note from 05 Nov 2013

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Committee members voting on rating do not own securities issued by the company.

Credit Analysis as of 20 Aug 2013
Business Analysis as of 30 Apr 2013
Estimates as of 08 Aug 2013

Currency amounts expressed with “$” are in U.S. dollars (USD) unless otherwise denoted.

Contents

Credit Perspective 20 Aug 2013

We are maintaining our credit rating for Zoetis at BBB+, reflecting its wide moat and manageable debt position. As the leading provider of animal health products, Zoetis possesses many sustainable competitive advantages that should ensure large, steady cash flow to service its debt obligations. We believe Zoetis' wide economic moat stems primarily from intangible assets and scale. In terms of intangible assets, about 20% of its sales come from patent-protected products while strong brand names help protect the rest of its revenue stream. In terms of scale, Zoetis' broad product portfolio helps it support a direct salesforce and bypass distributors, allowing it to control its marketing message and retain more cash flow at the same time. Overall, we believe its continued success in direct sales efforts should prevent competitors from easily supplanting Zoetis' dominant position in the animal health business. Also, development requirements to introduce new animal health products can be time-consuming and costly, which provides another barrier to entry into Zoetis' niche.

As a spin-off from Pfizer (rating: AA), Zoetis is starting off with net debt/EBITDA around 3 times. Although higher than possible in the long run, that leverage level looks easily manageable by the firm, especially since interest rates incurred on its recently issued debt were near historic lows. If profits rise as we expect and Zoetis pays off its 2016 and 2018 maturities rather than refinancing them, the firm could approach a net cash position by early 2018. Also in late June, Pfizer fully unloaded its stake in Zoetis to shareholders. We see Zoetis gaining more independence from its parent company as a positive development for our rating. With that increased independence and the potential for deleveraging in its near future, we see upgrade potential at Zoetis in the next couple years.

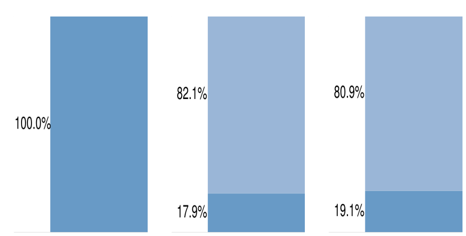
Credit Metrics (USD Mil)

	2011	2012	2013(E)	2014(E)
Cash And Equivalents	79	300	*881*	*1,369*
Total Debt	575	3,640	*3,640*	*3,640*
Interest Expense	—	—	*116*	*120*
EBITDA	837	1,193	*1,345*	*1,422*
Debt to Book Capital	0.1	0.8	*0.7*	*0.6*
Quick Ratio	1.5	2.0	*2.8*	*3.5*
Debt to EBITDA	0.7	3.1	*2.7*	*2.6*
EBITDA to Interest Expense	—	—	*11.5*	*11.8*

Operating Summary (USD Mil)

	2011	2012	2013(E)	2014(E)
Sales	4,233	4,318	*4,518*	*4,830*
% Change	18.2	2.0	*4.6*	*6.9*
EBIT	632	988	*1,137*	*1,217*
% Net Sales	14.9	22.9	*25.2*	*25.2*
Net Income	503	597	*723*	*775*
% Net Sales	11.9	13.8	*16.0*	*16.0*
Free Cash Flow	-8	335	*794*	*748*
% Net Sales	-0.2	7.8	*17.6*	*15.5*

Capital Structure



	Prior Year	Prior Quarter	Current
Market Equity	—	16.7 Bil	15.45 Bil
Preferred	—	—	—
Debt	573 Mil	3.65 Bil	3.65 Bil

Source: Morningstar

Issuer Profile

Zoetis sells anti-infectives, vaccines, parasiticides, and other health products for animals. The firm gets the majority of its revenue from production animals (cattle, pigs, poultry, etc.) but also sells companion animal (dogs, horses, cats) products. The firm has the largest market share in the industry and was previously Pfizer's animal health unit.

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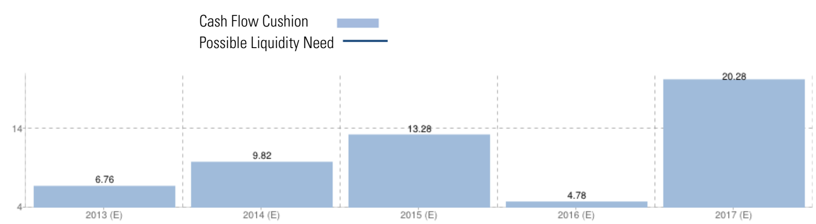
Credit Analysis

Five Year Adjusted Cash Flow Forecast (USD Mil)

	2013(E)	*2014(E)*	*2015(E)*	*2016(E)*	*2017(E)*
Cash and Equivalents (beginning of period)	*300*	*881*	*1,369*	*1,896*	*2,064*
Adjusted Available Cash Flow	*707*	*617*	*658*	*711*	*763*
Total Cash Available before Debt Service	*1,007*	*1,498*	*2,027*	*2,608*	*2,827*
Principal Payments	—	—	—	*-400*	—
Interest Payments	*-116*	*-120*	*-120*	*-114*	*-107*
Other Cash Obligations and Commitments	*-33*	*-33*	*-33*	*-33*	*-33*
Total Cash Obligations and Commitments	*-149*	*-153*	*-153*	*-546*	*-139*

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	300	26.3
Sum of 5-Year Adjusted Free Cash Flow	3,457	303.3
Sum of Cash and 5-Year Cash Generation	3,757	329.6
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	3,757	329.6
Sum of 5-Year Cash Commitments	-1,140	—

Credit Rating Pillars–Peer Group Comparison

	ZTS	Sector	Universe
Business Risk	4	5.0	5.2
Cash Flow Cushion	4	5.3	6.1
Solvency Score	4	4.4	5.0
Distance to Default	2	3.4	3.9
Credit Rating	BBB+	A-	BBB+

Source: Morningstar Estimates

Note: Scoring is on a scale 1-10, 1 being Best, 10 being Worst

Financial Health

We expect Zoetis to generate significant free cash flow and have no trouble meeting its debt obligations. In the near term, the firm is expected to face increased costs due to operating as an independent firm, but we believe it should quickly be able to return excess capital to shareholders. The firm initially plans to issue a $0.26 annual dividend, but we believe it will have significant capacity to raise the dividend or pursue a stock buyback in the near future.

Capital Structure

Zoetis recently issued $3.65 billion of debt and holds $300 million in cash. Zoetis issued the debt when available borrowing rates were near historic lows, so we do not expect the firm to have any trouble meeting its obligations. The debt includes $400 million of 1.15% notes due 2016, $750 million of 1.875% notes due 2018, $1.35 billion of 3.25% notes due 2023, and $1.15 billion of 4.7% notes due 2043.

Enterprise Risk

The FDA recently updated guidelines for the use of antibiotics in animals. The new guidelines call for voluntary monitoring of use in animals, so we do not expect it to have a significant impact on Zoetis sales; however, there is risk that the FDA could eventually issue more restrictive guidelines.

Zoetis Inc ZTS (NYSE) | BBB+

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Business Analysis

Thesis

Zoetis is the first opportunity for a direct investment in one of the major global animal health players, and it has faced a very warm reception from the market. We believe the previously underfollowed industry carries very attractive characteristics. Animal drugmakers sell to a highly fragmented market of cash-pay buyers, so they possess significant pricing power and see very low generic utilization. The industry also has favorable tailwinds that should provide solid long-term growth. On the production side, rising standards of living in emerging markets should lead to wider adoption of meat-heavy diets. In the companion business, owners are increasingly viewing pets as members of the family and have shown an increased willingness to pay for premium health-care treatment for their animals.

Zoetis' minimal economic sensitivity, high diversification, and low dependence on patents should provide very stable revenue. Despite the weak global economy, Zoetis' organic growth has held up very well. Although meat consumption may be negatively affected by a weak economy, it is not typically one of the first places consumers look to cut expenses. On the companion side, the economy has only a small impact on spending. Owners are likely to cut back on other discretionary spending before forgoing treatment for a pet. The economy may affect the decision to get a new pet, but it has a small impact on owners who already have one. Zoetis is also immune to patent cliffs that add volatility to human drugmakers' sales and earnings. The majority of the firm's products are off patent and are able to maintain or increase sales; given minimal generic competition, there is little risk of a product's sales evaporating overnight upon patent expiration. Zoetis is further isolated because of its extremely high diversification. The company's top product makes up just 8% of sales, and its top 10 products make up just 38% of sales.

The firm's market-leading position in emerging markets makes Zoetis best positioned to take advantage of growth opportunities. The key growth driver of the industry will be demand from the emerging markets. When standards of living increase, demand for animal protein increases dramatically. Zoetis holds leading share in the Asia/Pacific and Canada/Latin American regions, which are expected to see a 7%-8% compound annual growth rate over the next five years. The only one of the four geographic regions that Zoetis is not the leader in is the slowest-growing Europe/Africa/Middle East region.

Due to a fragmented customer base, Zoetis holds significant pricing power. On the human health side, firms are traditionally at the mercy of payers. Government payers or large managed-care organizations have the power to force generic utilization, squash price increases, and even in extreme cases force price cuts onto drug manufacturers. Conversely, animal health products are purchased by a fragmented group of meat producers, veterinarians, and pet owners, allowing very little bargaining power over the highly concentrated animal health firms.

Partially owing to lower gross margin products, Zoetis and the animal health industry as a whole are largely insulated from generic competition compared with what is traditionally seen in the human health market. With gross margins of just over 60%, there is very little opportunity for a generic manufacturer to come in and undercut on price. Pfizer posts companywide gross margins of more than 80% excluding the animal health unit, and that includes the low gross margin consumer unit and royalty payments that are recognized as cost of goods sold. The true manufacturing cost of human pharmaceutical products is probably 10% of sales or less, which is why generic firms can profitably offer massive discounts to branded products. Generic firms traditionally make up for a lower gross margin with selling, general, and administrative expense savings since

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Business Analysis

prescriptions can be automatically filled with generics and a sales force is unnecessary. However, with animal health that is not the case; generic firms would still need to employ a sales force to convince farmers and veterinarians to directly purchase their generic products. Similarly, the lower research and development spending in animal health versus human health leaves less room for additional savings from generic manufacturers. There is currently no large global generic manufacturer in the market.

Economic Moat

Zoetis earns a wide economic moat as a result of its intangible assets and scale. Although patents are not essential for maintaining a product in the animal health industry, 20% of the firm's revenue comes from products protected by patents that allow Zoetis to charge a premium price and insulate it from competition. Its strong brand name gives Zoetis another advantage over competitors. When customers are using drugs on potentially millions of dollars' worth of livestock, or a pet that they love like a family member, they will be willing to pay a premium to buy from a firm they trust.

Scale also provides Zoetis with a key advantage. Because of the highly fragmented customer base, the sales force, distribution, and relationships are extremely important. Launching a new product is not as simple as getting one large payer (managed-care organization, Medicare, or government) on board; the company needs to individually deal with veterinarians and meat producers. Zoetis' broad portfolio can support its own sales force, allowing the firm to bypass distributors.

Barriers to entry are significant in both capital and time. Although not nearly as expensive or as time-consuming as in human health, it is still very challenging to bring a new animal health product to market. Given the small market size and relatively modest sales potential of products, the reward often will not justify a new competitor pursuing clinical trials to bring a product to market.

One of the best examples of the strength of Zoetis' moat is its pain medication for dogs, Rimadyl. The product lost patent exclusivity in 2001, but sales are currently 35% higher than they were in 2001. Vets' relationship and trust in Zoetis have allowed Rimadyl to maintain and increase sales despite generic competition.

Moat Trend

We believe Zoetis has a stable moat trend. The firm competes in a very mature industry that is not experiencing any significant changes. With the heavy concentration among top firms and few revolutionary products in development, we do not expect the industry to face any material changes to its competitive landscape.

Stewardship

With limited results by which to judge current management, we default to a standard stewardship rating. Juan Ramon Alaix has been president of Pfizer Animal Health since 2006 and will be CEO of Zoetis. Under his leadership, Pfizer's animal health unit successfully integrated Fort Dodge Animal Health and Alpharma. Before that, he was regional president of Central/Southern Europe for Pfizer's pharmaceutical division. We believe his seven years running the company give him significant operational experience, but he will be faced with many new challenges running an independent public company rather than a subsidiary. Zoetis' CFO will be Richard Passov, who has spent more than 15 years in Pfizer's finance department, most recently as senior vice president and treasurer.

Acquisition opportunities are limited in the animal health industry, so we expect the majority of Zoetis' free cash flow to be returned to shareholders. The firm plans to initiate a quarterly dividend of $0.065 per share, which should result

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in about a 1% dividend yield. Debt repayment will require only a small amount of free cash flow, so Zoetis should have the capacity to increase its dividend or initiate a stock repurchase program.

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Recent Notes from our Credit and Equity Analysts

Zoetis Posts In-Line 3Q Results 05 Nov 2013

Zoetis reported third-quarter results that were in line with our expectations. The firm's top line grew 8% due to high-single-digit growth across all major geographic regions, and adjusted EPS grew 10%. Management slightly raised its full-year adjusted EPS guidance, from $1.36-$1.42 to $1.38-$1.42, but we do not plan to change our fair value estimate or wide moat rating.

Revenue grew 9% operationally over the prior year. Surprisingly, the developed markets posted the strongest growth this quarter. Europe had been Zoetis' slowest-growing segment for most of the year but posted 9% constant currency growth this quarter. The U.S. posted 10% growth, but results were slightly inflated because of last year's drought causing weak prior-year comparisons. Latin America and the Asia Pacific geographic segments posted 9% and 7% growth, respectively. Long term, we still expect the emerging markets to be the key growth drivers for the company and increase at rates above the developed markets.

Operating margin for the quarter was 24.8%, a slight improvement from 24.4% in the prior year. The firm's improvement was largely due to a reduction in research and development spending. We expect the firm to continue to benefit from leveraging its selling, general, and administrative expenses as it grows, but it will be partially offset by the lower-margin emerging markets making up a larger portion of revenue. Zoetis plans to launch Actogain, a beta-agonist for cattle, in late 2014, which would compete in the market that Merck's Zilmax was just removed from, but given the firm's diversification we do not anticipate it having a material impact on the company's growth rate.

Zoetis 2Q Results Meet Expectations, Shares Remain Overvalued 06 Aug 2013

Zoetis reported second-quarter results that were in line with our expectations. Management reiterated its full-year guidance, and we do not plan any changes to our fair value estimate. We continue to award Zoetis a wide economic moat, but we believe the shares are overvalued at approximately 22 times 2013 estimated EPS. We believe the market is pricing in too-optimistic expectations that Zoetis as an independent company will be able to significantly cut costs and increase earnings well in excess of revenue growth.

Revenue rose 5% on a constant currency basis, which is at the low end of management's expectation of a long-term market growth rate of 5%-7%. Weakness in Europe continues to weigh on the firm, with the European livestock business reporting a 2% decline. The U.S. companion business also slowed significantly this quarter, reporting a 2% growth rate versus the 13% growth rate it reported in the first quarter. The change was partially due to a significant drop in sales of the firm's Revolution product as a result of renewed competition. Novartis had pulled its Sentinel product line from the market in the first quarter, leading to a significant increase in sales of Pfizer's Revolution, but in the second quarter Sentinel returned to the market with a 50% price cut. Novartis has stated the new lower price is a permanent price, rather than a temporary promotion, so we expect Revolution sales to remain under pressure.

Zoetis' adjusted earnings per share of $0.36 was essentially flat with the $0.35 reported in the same quarter last year. A lower SG&A ratio and tax rate helped increase earnings, but were offset by a slightly lower gross-margin and higher interest expense related to the firm's recently issued debt. Operating margin for the quarter was 25.5% versus 25.0% in the prior quarter. We expect Zoetis to continue seeing

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operating margin improvement in the coming years, although the firm already posts margins well above the industry norm and we think it is unlikely to reach Sanofi animal health's 29%-30% operating margin given that Zoetis lacks a blockbuster consumer product like Sanofi's Frontline.

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Morningstar Analyst Forecasts

Income Statement (USD Mil)
Fiscal Year Ends in December

	2010	2011	2012	*Forecast* 2013	*Forecast* 2014
Revenue	**3,582**	**4,233**	**4,318**	***4,518***	***4,830***
Cost of Goods Sold	1,444	1,652	1,554	*1,604*	*1,715*
Gross Profit	**2,138**	**2,581**	**2,763**	***2,914***	***3,115***
Selling, General & Administrative Expenses	1,382	1,453	1,295	*1,396*	*1,473*
Research & Development	411	427	432	*384*	*425*
Other Operating Expense (Income)	—	—	—	*-3*	—
Depreciation & Amortization (if reported separately)	58	69	48	—	—
Operating Income (ex charges)	**287**	**632**	**988**	***1,137***	***1,217***
Restructuring & Other Cash Charges	109	238	55	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**178**	**394**	**933**	***1,137***	***1,217***
Interest Expense	—	—	—	*116*	*120*
Interest Income	—	—	14	—	—
Pre-Tax Income	**178**	**394**	**947**	***1,020***	***1,097***
Income Tax Expense	67	146	350	*297*	*323*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	-1	-3	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**110**	**245**	**597**	***723***	***775***
Weighted Average Diluted Shares Outstanding	505	505	500	*500*	*500*
Diluted Earnings Per Share	**0.22**	**0.49**	**1.19**	***1.45***	***1.55***
Adjusted Net Income	275	503	597	*723*	*775*
Diluted Earnings Per Share (Adjusted)	**0.55**	**1.00**	**1.19**	***1.45***	***1.55***
Dividends Per Common Share	0.41	0.82	0.83	*0.26*	*0.35*
EBITDA	**363**	**599**	**1,138**	***1,345***	***1,422***
Adjusted EBITDA	**472**	**837**	**1,193**	***1,345***	***1,422***

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Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December	2010	2011	2012	*Forecast* 2013	*Forecast* 2014
Cash and Equivalents	63	79	300	*881*	*1,369*
Investments	—	—	—	—	—
Accounts Receivable	773	871	848	*866*	*926*
Inventory	995	1,063	1,136	*1,169*	*1,250*
Deferred Tax Assets (Current)	97	96	68	*68*	*68*
Other Short Term Assets	188	202	225	*225*	*225*
Current Assets	**2,116**	**2,311**	**2,577**	***3,209***	***3,838***
Net Property Plant, and Equipment	1,148	1,243	1,229	*1,196*	*1,181*
Goodwill	934	989	981	*981*	*981*
Other Intangibles	924	928	877	*877*	*877*
Deferred Tax Assets (Long-Term)	70	143	100	*100*	*100*
Other Long-Term Operating Assets	92	97	73	*73*	*73*
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	**5,284**	**5,711**	**5,837**	***6,436***	***7,050***
Accounts Payable	206	214	192	*198*	*212*
Short-Term Debt	38	—	—	—	—
Deferred Tax Liabilities (Current)	24	18	—	—	—
Other Short-Term Liabilities	540	611	527	*527*	*527*
Current Liabilities	**808**	**843**	**719**	***725***	***739***
Long-Term Debt	673	575	3,640	*3,640*	*3,640*
Deferred Tax Liabilities (Long-Term)	218	311	254	*254*	*254*
Other Long-Term Operating Liabilities	141	124	165	*165*	*165*
Long-Term Non-Operating Liabilities	100	122	—	—	—
Total Liabilities	**1,940**	**1,975**	**4,778**	***4,784***	***4,798***
Preferred Stock	—	—	—	—	—
Common Stock	3,418	3,785	5	*5*	*5*
Additional Paid-in Capital	—	—	1,234	*1,234*	*1,234*
Retained Earnings (Deficit)	-74	-65	-195	*398*	*998*
(Treasury Stock)	—	—	—	—	—
Other Equity	—	16	—	—	—
Shareholder's Equity	**3,344**	**3,736**	**1,044**	***1,637***	***2,237***
Minority Interest	—	—	15	*15*	*15*
Total Equity	**3,344**	**3,736**	**1,059**	***1,652***	***2,252***

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Morningstar Analyst Forecasts

Cash Flow (USD Mil)
Fiscal Year Ends in December

				Forecast	
	2010	2011	2012	*2013*	*2014*
Net Income	111	248	248	*723*	*775*
Depreciation	185	205	205	*208*	*205*
Amortization	—	—	—	—	—
Stock-Based Compensation	16	19	19	*20*	*22*
Impairment of Goodwill	16	78	78	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-68	65	65	—	—
Other Non-Cash Adjustments	-106	-1	-1	—	—
(Increase) Decrease in Accounts Receivable	30	-85	-85	*-18*	*-60*
(Increase) Decrease in Inventory	117	40	40	*-33*	*-81*
Change in Other Short-Term Assets	-19	11	11	—	—
Increase (Decrease) in Accounts Payable	25	-16	-16	*6*	*14*
Change in Other Short-Term Liabilities	-53	-67	-67	—	—
Cash From Operations	**254**	**497**	**497**	***907***	***874***
(Capital Expenditures)	-124	-135	-135	*-175*	*-190*
Net (Acquisitions), Asset Sales, and Disposals	-81	-345	-345	—	—
Net Sales (Purchases) of Investments	203	34	34	—	—
Other Investing Cash Flows	-7	-3	-3	—	—
Cash From Investing	**-9**	**-449**	**-449**	***-175***	***-190***
Common Stock Issuance (or Repurchase)	—	—	—	—	—
Common Stock (Dividends)	-207	-416	-416	*-130*	*-175*
Short-Term Debt Issuance (or Retirement)	—	—	—	—	—
Long-Term Debt Issuance (or Retirement)	—	-143	-143	—	—
Other Financing Cash Flows	-70	529	529	*-20*	*-22*
Cash From Financing	**-277**	**-30**	**-30**	***-150***	***-197***
Exchange Rates, Discontinued Ops, etc. (net)	-4	-2	-2	—	—
Net Change in Cash	**-36**	**16**	**16**	***581***	***488***

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Sanofi SNY USA	8,101 EUR	69.1	67.6	67.9	24.1	30.8	31.7	21.3	18.8	21.1	22.5	19.6	20.3	18.2	14.2	18.2
Merck & Co Inc MRK USA	11,743 USD	65.2	74.9	75.0	37.0	36.2	36.8	22.3	21.4	22.6	24.8	23.8	23.3	17.1	17.1	20.2
Eli Lilly and Company LLY USA	3,784 USD	78.8	79.0	75.0	32.0	27.8	22.8	25.5	24.6	19.6	16.7	19.8	15.4	19.5	17.5	16.7
Average		71.0	73.8	72.6	31.0	31.6	30.4	23.0	21.6	21.1	21.3	21.1	19.7	18.3	16.3	18.4
Zoetis Inc ZTS US	**597** USD	**64.0**	**64.5**	**64.5**	**27.6**	**29.8**	**29.5**	**22.9**	**25.2**	**25.2**	**13.8**	**16.0**	**16.0**	**8.4**	**16.2**	**14.2**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Sanofi SNY USA	14,531 EUR	25.3	27.3	25.6	20.2	21.4	20.4	15.7	16.9	20.1	1.7	1.5	1.4	1.8	1.7	1.7
Merck & Co Inc MRK USA	20,569 USD	38.8	46.3	44.5	28.0	31.7	30.8	24.5	20.1	18.6	1.2	1.4	1.3	2.0	2.1	2.1
Eli Lilly and Company LLY USA	5,531 USD	37.5	40.9	39.6	27.3	29.0	28.4	40.6	42.2	27.8	0.8	1.0	1.4	2.3	2.3	2.2
Average		33.9	38.2	36.6	25.2	27.4	26.5	26.9	26.4	22.2	1.2	1.3	1.4	2.0	2.0	2.0
Zoetis Inc ZTS US	**3,640** USD	**348.7**	**222.3**	**162.7**	**77.7**	**69.0**	**61.9**	**—**	**11.5**	**11.8**	**3.1**	**2.7**	**2.6**	**5.6**	**3.9**	**3.2**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Sanofi SNY USA	140,536 USD	4.97	7.29	8.71	1.65	1.98	2.13	1.18	1.50	1.65	1.72	2.53	3.02	63.9	90.9	75.2
Merck & Co Inc MRK USA	132,740 USD	7.62	8.43	8.15	2.30	2.78	2.65	1.94	2.40	2.28	5.43	12.23	11.57	82.9	108.1	95.1
Eli Lilly and Company LLY USA	56,749 USD	5.09	5.55	5.91	1.55	1.48	1.45	1.24	1.17	1.14	477.67	5.48	5.50	53.6	45.0	70.8
Average		5.89	7.09	7.59	1.83	2.08	2.08	1.45	1.69	1.69	161.61	6.75	6.70	66.8	81.3	80.4
Zoetis Inc ZTS US	**15,845** USD	**0.60**	**1.76**	**2.74**	**3.58**	**4.43**	**5.19**	**2.00**	**2.81**	**3.50**	**—**	**—**	**—**	**69.7**	**18.0**	**22.6**

Morningstar's Approach to Rating Corporate Credit

- Offers a proprietary measure of the credit quality of companies on our coverage list.
- Encapsulates our in-depth modeling and quantitative work in one letter grade.
- Allows investors to rank companies by each of the four underlying components of our credit ratings, including both analyst-driven and quantitative measures.
- Provides access to all the underlying forecasts that go into the rating, available through our institutional service.

Purpose

The Morningstar Corporate Credit Rating measures the ability of a firm to satisfy its debt and debt-like obligations. The higher the rating, the less likely we think the company is to default on these obligations.

The Morningstar Corporate Credit Rating builds on the modeling expertise of our securities research team. For each company, we publish:

- Five years of detailed pro-forma financial statements
- Annual estimates of free cash flow
- Annual forecasts of return on invested capital
- Scenario analyses, including upside and downside cases
- Forecasts of leverage, coverage, and liquidity ratios for five years
- Estimates of off balance sheet liabilities

These forecasts are key inputs into the Morningstar Corporate Credit Rating and are available to subscribers at select.morningstar.com.

Methodology

We feel it's important to perform credit analysis through different lenses—qualitative and quantitative, as well as fundamental and market-driven. We therefore evaluate each company in four broad categories.

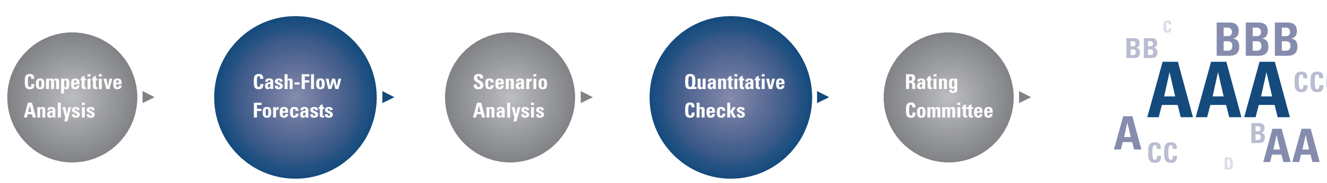
Business Risk

Business Risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. Key components of the Business Risk rating include the Morningstar Economic Moat™ Rating and the Morningstar Uncertainty Rating.

Cash Flow Cushion™

Morningstar's proprietary Cash Flow Cushion™ ratio is a fundamental indicator of a firm's future financial health The measure reveals how many times a company's internal cash generation plus total excess liquid cash will cover its debt-like contractual commitments over the next five years. The Cash Flow Cushion acts as a predictor of financial distress, bringing to light potential refinancing, operational, and liquidity risks inherent to the firm.

Morningstar Research Methodology for Determining Corporate Credit Ratings



Competitive Analysis: Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade show visits
- Competitor, supplier, distributor, and customer interviews
- Assign Economic Moat™ Rating

Cash-Flow Forecasts: Analyst considers company financial statements and competitive dynamics to forecast future free cash flows to the firm.

Analyst derives estimate of Cash-Flow Cushion™.

Scenario Analysis: Analysts run bull and bear cases through the model to derive alternate estimates of enterprise value.

Based on competitive analysis, cash-flow forecasts, and scenario analysis, the analyst assigns Business Risk.

Quantitative Checks: We gauge a firm's health using quantitative tools supported by our own backtesting and academic research.

- Morningstar Solvency Score™
- Distance to Default

Rating Committee: Senior personnel review each company to determine the appropriate final credit rating.

- Review modeling assumptions
- Approve company-specific adjustments

AAA	Extremely Low Default Risk
AA	Very Low Default Risk
A	Low Default Risk
BBB	Moderate Default Risk
BB	Above Average Default Risk
B	High Default Risk
CCC	Currently Very High Default Risk
CC	Currently Extreme Default Risk
C	Imminent Payment Default
D	Payment Default
UR	Under Review
UR+	Positive Credit Implication
UR-	Negative Credit Implication

Morningstar's Approach to Rating Corporate Credit

The advantage of the Cash Flow Cushion ratio relative to other fundamental indicators of credit health is that the measure focuses on the future cash-generating performance of the firm derived from Morningstar's proprietary discounted cash flow model. By making standardized adjustments for certain expenses to reflect their debt-like characteristics, we can compare future projected free cash flows with debt-like cash commitments coming due in any particular year. The forward-looking nature of this metric allows us to anticipate changes in a firm's financial health and pinpoint periods where cash shortfalls are likely to occur.

Morningstar Solvency Score™

The Morningstar Solvency Score™ is a quantitative score derived from both historical and forecasted financial ratios. It includes ratios that focus on liquidity (a company's ability to meet short term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how does the company finance its operations), and interest coverage (how much of profit is used up by interest payments).

Distance to Default

Morningstar's quantitative Distance to Default measure ranks companies on the likelihood that they will tumble into financial distress. The measure is a linear model of the percentile of a firm's leverage (ratio of Enterprise Value to Market Value), the percentile of a firm's equity volatility relative to the rest of the universe and the interaction of these two percentiles. This is a proxy methodology for the common definition of Distance to Default which relies on option-based pricing models. The proxy has the benefit of increased breadth of coverage, greater simplicity of calculation, and more predictive power.

For each of these four categories, we assign a score, which we then translate into a descriptive rating along the scale of Very Good / Good / Fair / Poor / Very Poor.

Overall Credit Rating

The four component ratings roll up into a single preliminary credit rating. To determine the final credit rating, a credit committee of at least five senior research personnel reviews each preliminary rating.

We review credit ratings on a regular basis and as events warrant. Any change in rating must be approved by the Credit Rating Committee.

Investor Access

Morningstar Corporate Credit Ratings are available on Morningstar.com. Our credit research, including detailed cash-flow models that contain all of the components of the Morningstar Corporate Credit Rating, is available to subscribers at select.morningstar.com.