

Zoetis, Inc.

(ZTS - \$31.46)

January 27, 2014

Company Update **Note**

Medical Devices & Supplies

Strong Buy
\$41.00

Trading Data:

Last Price (1/24/2014)	\$31.46
52-Week High (3/14/2013)	\$35.42
52-Week Low (8/28/2013)	\$28.81
Market Cap. (MM)	\$15,730
Shares Out. (MM)	500.007
3 Month Avg. Daily Vol. (MM)	3.416

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	20.0	18.0	23.4
EV / EBITDA	13.2	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.

Google Trends Shows Interest in Apoquel Is Rising Rapidly

- Google Trends data indicate searches for Apoquel have been rising rapidly over the last 11 weeks. Interestingly, Google Trends shows search volumes for Apoquel are already equivalent to those of Atopica. In addition, searches for Apoquel are rising at a pace similar to those for Trifexis at the time of its launch three years ago.
- While it is still early, we believe the data from Google Trends supports peak revenue projections for Apoquel, which we discussed in our January 25 report.
- Apoquel increases our confidence in our projection of 6% compound annual revenue growth for Zoetis over the next five years. We do not believe investors fully appreciate the revenue potential of Apoquel. We reiterate our Strong Buy rating.

We use Google Trends to evaluate interest in Apoquel: To supplement our January 21 report about Zoetis' new drug, Apoquel, within this report we use Google Trends to evaluate the current level of customer interest in the product. As a reminder, Apoquel is a novel drug for treatment of pruritus (itching) associated with allergic dermatitis and atopic dermatitis in dogs at least 12 months of age. Zoetis conducted a controlled launch of Apoquel, or "Early Experience Program," primarily with veterinary dermatologists during the last one or two quarters. The company initiated a broad market launch focused on general veterinary practitioners on January 20, during the North American Veterinary Conference (NAVC).

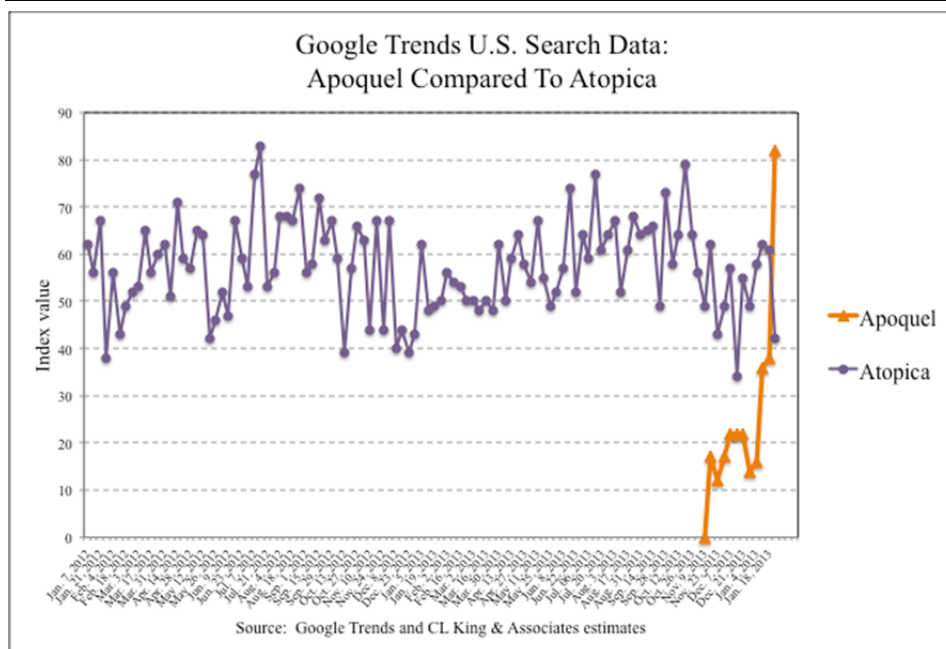
Google searches for Apoquel have been rising rapidly and are now on par with those for Atopica: As illustrated in Chart 1 below, Google searches for Apoquel have been at sufficient levels to register within the Google Trends tool during the most recent 11 weeks. Importantly, Google searches for Apoquel have been increasing rapidly during this 11-week period and they increased dramatically last week following Apoquel's broad market launch at NAVC.

In addition, the number of searches for Apoquel is at about the same level as those for Novartis' (NVS^^: NR) Atopica (cyclosporine). As discussed in our January 21 report, current treatments for pruritic, or "itchy," dogs largely consist of corticosteroids and Atopica. However, Atopica's use is generally limited to more complex cases, while the use of corticosteroids is much more common. We view the fact that Apoquel has already achieved Google search volumes that are equivalent to Atopica as significant since both drugs are used to treat itching

associated with dermatitis. We estimate Atopica has annual revenues in the U.S. of roughly \$50MM, though we emphasize this estimate is very approximate.

Chart 1: Google Trends - Apoquel Search Volumes, with a Comparison to Atopica

Google Trends shows searches for Apoquel have risen rapidly. Interestingly, search volumes for Apoquel are already similar to those of Atopica.



Note: The data consists of searches for "Apoquel" and for "Atopica" within the U.S. The most recent data is for week ending January 25, 2014.

Source: Google Trends and CL King & Associates estimates.

Searches for Apoquel are rising at a pace similar to those for Trifexis at the time of its launch three years ago: We thought it would also be useful to compare the search trends for Apoquel to the search volume for Trifexis, a highly successful flea and heartworm preventative launched three years ago.

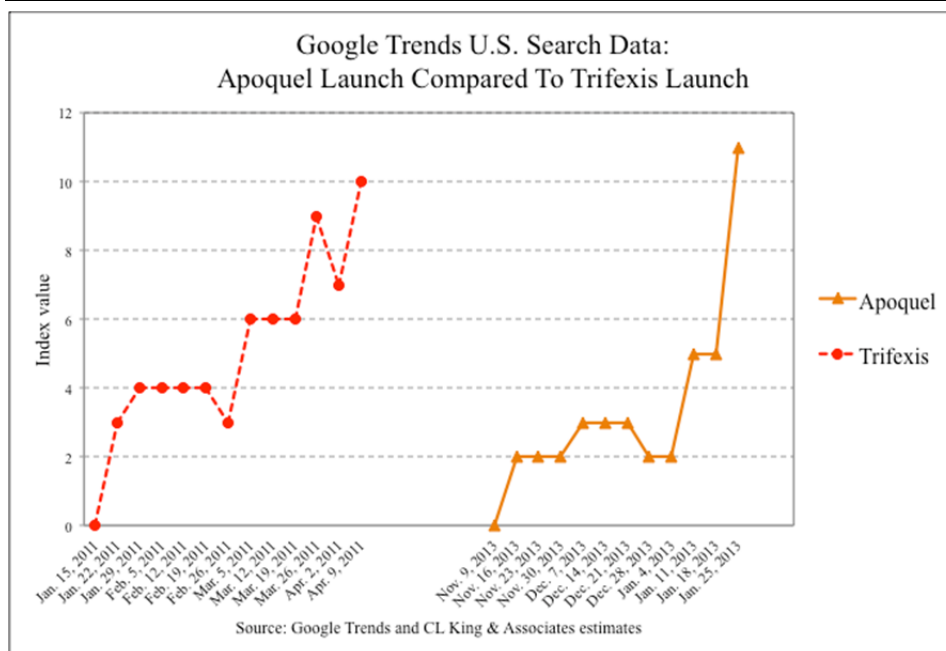
Specifically, Chart 2 below shows the growth in searches for Apoquel during the most recent 11 weeks has closely paralleled the growth of searches for Trifexis during the first 12 weeks following its market launch in 2011.

As additional background, Eli Lilly's (LLY: NR) Trifexis is a flea and heartworm preventative that was launched on the market in January 2011 at NAVC. Trifexis has been a very successful drug during the three years since its launch. We estimate Trifexis' revenues were in the neighborhood of \$300MM in 2013.

Chart 2: Google Trends Search Volumes - Apoquel Launch vs. Trifexis Launch

Google Trends indicates searches for Apoquel are moving in parallel with searches for Trifexis at the time of its launch in early 2011.

While Trifexis is a flea and heartworm preventative, rather than a treatment for pruritus, we think it is an interesting comparator given its tremendous success over the last three years.



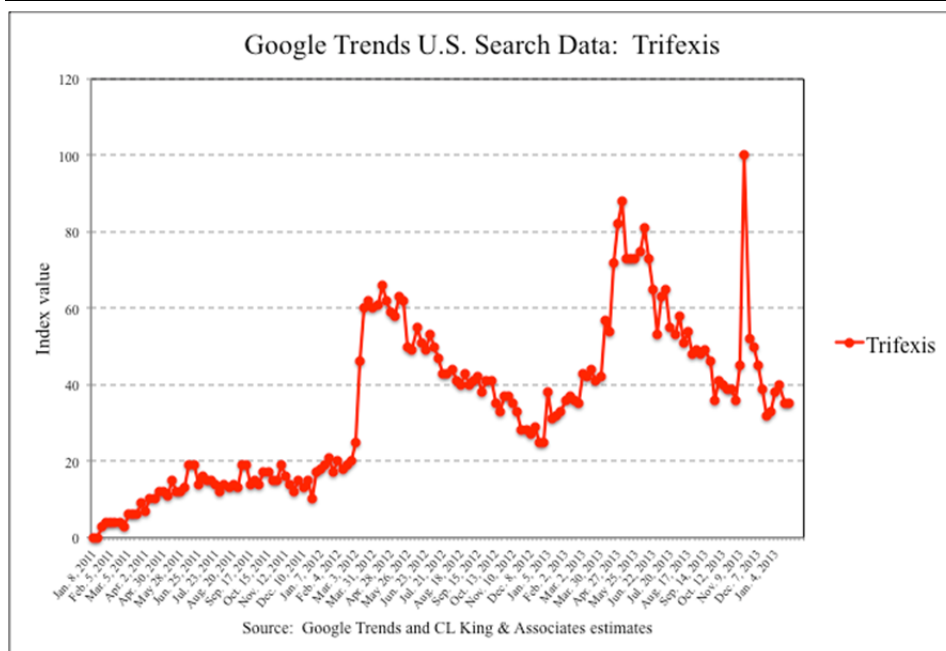
Note: The data consists of searches for Apoquel and for Trifexis within the U.S. The most recent data is for week ending January 25, 2014.

Source: Google Trends and CL King & Associates estimates.

We believe the early Google Trends data supports our peak revenue estimates for Apoquel: While it is still early, we believe the Google Trends data supports our estimate that Apoquel's peak global revenues should be in a range of \$200MM-\$400MM, which we discussed in our January 21 report. Moreover, we believe there is a higher probability peak revenues will be in the upper half of this range, rather than the lower half. The rapid rise in searches for Apoquel, the level of searches compared to Atopica, and the similarities to the search volumes for Trifexis at the time of its launch all suggest to us that customer interest in the drug is very high and that the market opportunity is significant.

Google Trends should be useful in gauging Apoquel's growth over time: We believe Google Trends search data for Apoquel will be useful in evaluating the approximate revenue growth trends of this drug over the next several years. As an example, based on our estimates, we believe Google Trends search data for Trifexis has been reasonably well correlated with the revenue growth of Trifexis over the last three years. Historical Google Trends search data for Trifexis is shown in Chart 3 below.

Chart 3: Google Trends Search Volumes for Trifexis



*Note: The data consists of searches for Trifexis within the U.S. The most recent data is for week ending January 25, 2014.
Source: Google Trends and CL King & Associates estimates.*

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. Also, we 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 currently 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 1: Valuation Multiples for Zoetis

Item	2012PF	2013E	2014E	2015E
Stock price	\$31.46	\$31.46	\$31.46	\$31.46
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	29.2 x	22.5 x	20.1 x	18.0 x
EV / EBITDA ratio	17.1 x	14.6 x	13.2 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)	\$15,730,000	\$15,815,609	\$15,974,359	\$16,134,703
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)	\$18,886,000	\$18,973,229	\$18,474,112	\$17,902,557

Source: CL King & Associates estimates

Risks

There are a number of potential risks that could have a negative affect on Zoetis' business and its stock. There is a risk 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. Also, 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 – 01/21/14

DISCLOSURES:

ANALYST CERTIFICATION

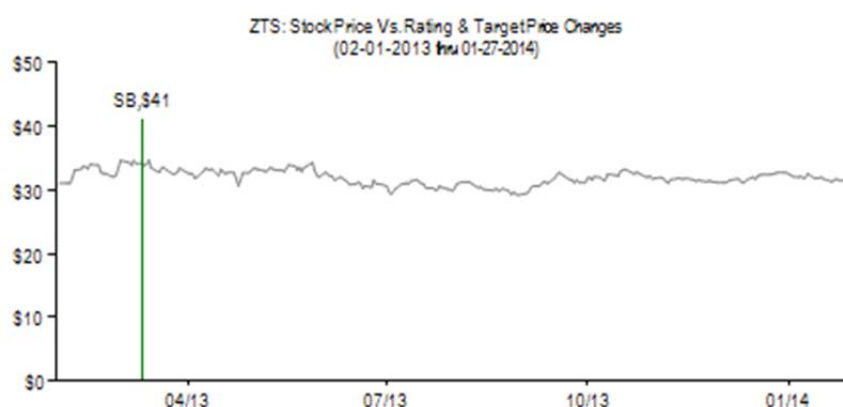
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Additional information available upon request.

^^ The covering analyst owns shares of the company.

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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: www.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.	14.55%	0.00%	1.82%
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.	39.09%	1.82%	0.91%
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.	42.73%	1.82%	2.73%
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.	0.91%	0.00%	0.00%

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