Zoetis, Inc.

(ZTS - $31.73)

August 6, 2013

Company Update | Note

Medical Devices & Supplies

Strong Buy
$41.00

Trading Data:

Last Price (8/06/2013)	$31.73
52–Week High (3/14/2013)	$35.42
52–Week Low (7/03/2013)	$28.97
Market Cap. (MM)	$15,625
Shares Out. (MM)	500
3 Month Avg. Daily Vol. (MM)	8.323

Estimates/TP Changes

Item	FY	Previous	Current
EPS ($)	FY14E	$1.50	$1.55
	FY13E	$1.36	$1.38

Earnings Estimates: ($ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY14E	0.39	0.41	0.37	0.38	1.55
FY13E	0.36A	0.36A	0.33	0.34	1.38
FY12A	0.30	0.35	0.30	0.12	1.08
FY11A	0.24	0.22	0.29	0.24	1.00

Valuation:

Multiple	Curr. FY	Next FY	Next FY @ PT
P/E	23.0	20.5	26.5
EV / EBITDA	15.1	13.6	17.0
EV / Revs	4.3	3.9	4.9

Source: CL King & Associates estimates

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See required disclosures at the end of report.

Very Good Q2; Revenue Outlook Favorable, in Our View

- Zoetis reported very good Q2 results, in our view, particularly given that we believe many investors were concerned about the challenging industry conditions. Organic revenue growth was 4%, which we view positively.

- We are raising our estimates slightly as a result of minor changes to our operating profit margin and income tax rate assumptions. Specifically we are increasing our 2013 EPS estimate to $1.38 from $1.36 and we are increasing our 2014 EPS estimate to $1.55 from $1.50.

- Similar to our own outlook, Zoetis management indicated it believes the impact of the 2012 drought in 2012 in the U.S. is starting to ease. We believe U.S. production animal fundamentals should improve in the latter half of 2013 and in 2014. We are anticipating modest improvement in Zoetis' revenues as a result of our expectation of some strengthening of its business in both the U.S. and international markets.

- We believe ZTS stock offers attractive risk-reward at present and we reiterate our Strong Buy rating. We believe Zoetis' business should strengthen over the next six to 12 months and that the long-term drivers of industry growth are still strong.

We view the Q2 results positively: Zoetis' Q2 (June) results were very good, in our view, and consistent with our expectations. We also view the results positively given that we believe many investors were concerned about the potential impact of challenging industry conditions on the company in Q2.

Organic revenue growth was very good in light of industry conditions: Revenues increased 4% on an operational basis in Q2. We do not believe acquisitions or divestures had an impact on the quarter, so we view the 4% figure as equivalent to organic growth for the quarter. Within our financial model we projected organic growth of 4.5%; given current industry conditions and our perception of investor concerns that growth in the quarter would be weak we view the 4% reported growth positively.

Growth in each of the regions was similar to our expectations. Operational growth was 4% in the U.S., 1% in Europe/Africa/Middle East, 4% in Canada/Latin America/Russia, and 7% in Asia/Pacific/China. On a global basis, operational growth for companion animals and production animals were 5% and 3%, respectively.

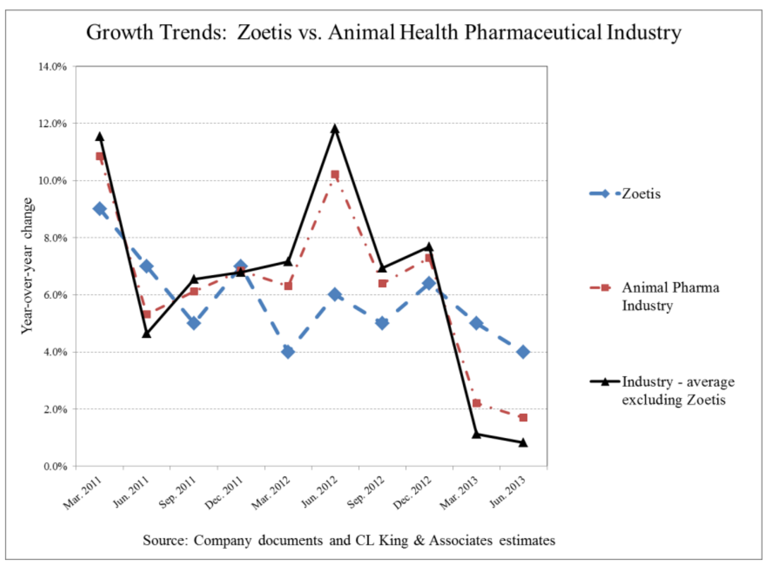
Summary of Q2 revenue and EPS: Reported revenues of $1,114MM compared to $1,094MM last year and our estimate of $1,151MM. As noted above, organic revenue growth was 0.5% slower than we modeled. In addition foreign currencies reduced revenues by 2%, which was more than we expected. We do not view the difference in the reported revenue result from our estimate as meaningful. Excluding adjustments, reported EPS were $0.36 compared to $0.35 last year and our estimate of $0.35. Expense margins and the 29.4% income tax rate were all very good, in our view.

Management's anticipation of improving industry fundamentals is consistent with our outlook: Similar to our own outlook and comments by a few other industry participants, Zoetis' management indicated it believes the impact of the 2012 drought in the U.S. is beginning to ease in some sectors of the production animal market. Management also stated that it believes the drought should have less of an impact on the U.S. cattle market in the second half of 2013 and that overall U.S. production animal conditions should further improve in 2014, assuming normal weather patterns.

We expect Zoetis' revenues to strengthen some from the Q2 pace of growth, and a few new products have potential: We believe incremental strength in the U.S. as well as in some of Zoetis' markets outside the U.S. should drive a modest strengthening in the company's revenues over the balance of 2013 and in 2014. Moreover, we believe some of the company's new products have the potential to add to its growth. In particular, we believe Apoquel and the RUI LAN AN vaccine for highly pathogenic porcine reproductive and respiratory syndrome developed by Zoetis' joint venture in China have the potential to be meaningful products.

Growth trends for Zoetis and the industry: For perspective, we present recent growth trends for Zoetis and the animal pharmaceutical industry in Chart 1 below. While growth slowed in the first half of this year, we expect some improvement in the second half of 2013 and in 2014.

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

We are raising our estimates slightly: We are raising our 2013 EPS estimate to $1.36 from $1.38 as a result of the $0.01 higher Q2 EPS compared to our estimate plus minor changes to our expense and tax assumptions for the second half of the year. In addition, we are increasing our 2014 EPS estimate of $1.55 from $1.50; the increase is driven by a slight increase in our operating profit margin projection and a slight decease in our income tax rate forecast. Management reiterated its 2013 EPS guidance of a range of $1.36 to $1.42. Our estimates and the guidance exclude unusual items and amortization expense related to historical acquisitions.

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 2: Valuation Multiples for Zoetis

Item	2012PF	2013E	2014E
Stock price	$31.73	$31.73	$31.73
Revenues (in 1,000's)	$4,336,000	$4,525,360	$4,833,764
EBITDA (in 1,000's)	$1,105,000	$1,272,182	$1,383,362
EPS - GAAP	$1.01	$1.34	$1.46
EPS adj to add back amortization exp.	**$1.08**	**$1.38**	**$1.55**
P / E ratio - based on adj. EPS	**29.4 x**	**23.0 x**	**20.5 x**
EV / EBITDA ratio	**17.2 x**	**15.1 x**	**13.6 x**
EV / Revenue ratio	**4.4 x**	**4.3 x**	**3.9 x**
ROA	9.2%	11.6%	13.2%
ROE	22.2%	61.7%	53.9%
Enterprise value computation:			
Equity market value (in 1,000's)	$15,865,000	$16,120,594	$16,282,405
Total debt (in 1,000's)	$3,640,000	$3,346,000	$2,546,000
Cash (in 1,000's)	$484,000	$212,390	$25,532
Enterprise value (in 1,000's)	$19,021,000	$19,254,204	$18,802,873

Source: CL King & Associates estimates

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Risks

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 - 06/03/13

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DISCLOSURES:

ANALYST CERTIFICATION

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Additional information available upon request.

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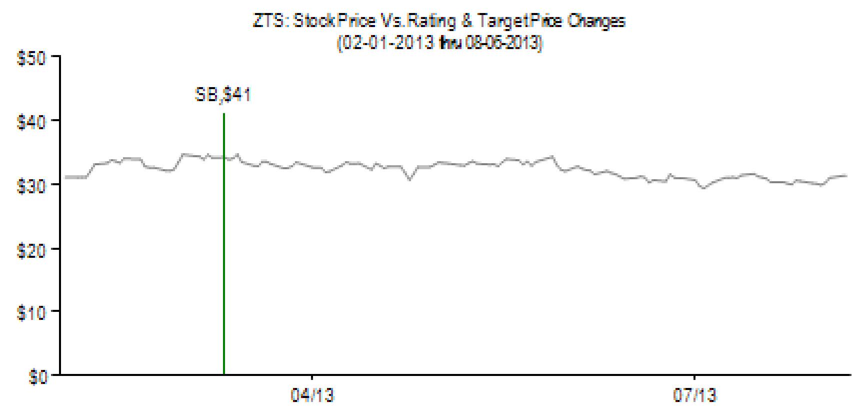
RATINGS INFORMATION

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.	14.69%	0.00%	2.10%
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.	37.06%	1.40%	0.70%
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.	47.55%	1.40%	1.40%
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.	0.70%	0.00%	0.00%

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