

## Zoetis Inc. (ZTS)

Overweight

Alternate Site Providers: Top Pick for 2014

### CONCLUSION

ZTS is our top large-cap pick in 2014 due to its leading industry position in the stable and mature animal health industry. We believe top-line growth can ramp from mid-single digits to high-single digit growth driven by 1) livestock recovery, specifically the rebuilding of cattle herds, 2) new product introductions, and 3) strategic acquisitions. There is evidence that the multi-year cattle recovery is underway as heifer demand and prices has increased. Additionally, we believe ZTS will continue to rationalize costs as a stand-alone company and the margin expansion story remains intact. Maintain Overweight rating and \$39 PT.

- **Improving livestock market could provide a multi-year tailwind.** While the number of cattle in the U.S. is at the lowest levels since the 1950s, we believe the cattle market is slowly recovering and should provide a multi-year tailwind as cattle farmers replenish their herds, which should lead to greater use of medications and vaccines. Comps get easier in 1H14 as ZTS experienced most of the impact from the drought in 2H12 and 1H13. The USDA Cattle on Feed reports indicate cattle placed on feed increased in both September and October, which will result in greater use of ZTS products. We believe rebuilding of the herds will be an incremental driver of growth for ZTS as cattle accounts for approximately 35% of revenues.
- **Companion animal trends remain favorable.** We believe the companion animal market will continue to grow in the mid-to-high single digits driven by increased pet ownership, greater willingness by pet owners to spend more on pets, and continued pet product innovation. For example, ZTS will launch APOQUEL, which helps control itching in dogs, in early 2014. Depending on price and uptake from vets, we believe APOQUEL could reach blockbuster status (>\$100 MM of revenues) over the next few years. Assuming revenues of \$50-\$100 MM, we estimate APOQUEL could generate incremental EPS of \$0.02-\$0.06. Additional new product launches, as well as strategic acquisitions, could help drive accelerating revenue growth.
- **Margin expansion story intact.** We believe ZTS will be able to drive significant operating margin expansion over the next few years as the company focuses on rationalizing costs as a stand-alone company. We expect margin expansion to be driven by incremental pricing growth, continued focus on manufacturing efficiencies, and disciplined SG&A spending. We estimate every 50 bps of operating margin expansion could add \$0.03 to annual EPS. ZTS currently trades at ~20x our FY14E EPS, which we believe is relatively attractive given the opportunity for accelerating top and bottom-line growth partially attributable to cost rationalization and margin expansion.

### RISKS TO ACHIEVEMENT OF PRICE TARGET

Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

### COMPANY DESCRIPTION

Zoetis is the leading global manufacturer of animal health medications and vaccines.

PRICE: US\$31.58

TARGET: US\$39.00

(24.5x FY14E EPS)

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	—	US\$4,516.2
FY14E Rev (mil)	—	US\$4,751.5
FY13E EPS	—	US\$1.40
FY14E EPS	—	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.0	
Market Cap. (mil)	US\$15,790.0	
Avg Daily Vol (ooo)	3,818	
Book Value/Share	US\$1.45	
Net Cash Per Share	US\$0.00	
Debt to Total Capital	83%	
Div (ann)	US\$0.26	
Yield	0.82%	
Fiscal Year End	Dec	

### Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2012A	1,047.0	1,094.0	1,019.0	1,176.0	4,336.0	3.6x	0.30	0.35	0.31	0.11	1.08	29.2x
2013E	1,090.0A	1,114.0A	1,103.0A	1,209.2	4,516.2	3.5x	0.36A	0.36A	0.34A	0.34	1.40	22.6x
2014E	1,142.2	1,172.0	1,166.5	1,270.8	4,751.5	3.3x	0.40	0.39	0.40	0.40	1.59	19.9x

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Period	FY09	FY10	FY11	FY12	1Q13	2Q13	3Q13	4Q13E	FY13E	1Q14E	2Q14E	3Q14E	4Q14E	FY14E	1Q15E	2Q15E	3Q15E	4Q15E	FY15E
Ending	12/31/09	12/31/10	12/31/11	12/31/12	3/31/13	6/30/13	9/30/13	12/31/13	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	12/31/14	3/31/15	6/30/15	9/30/15	12/31/15	12/31/15
Revenues	\$2,760.0	\$3,582.0	\$4,233.0	\$4,336.0	\$1,090.0	\$1,114.0	\$1,103.0	\$1,209.2	\$4,516.2	\$1,142.2	\$1,172.0	\$1,166.5	\$1,270.8	\$4,751.5	\$1,201.4	\$1,236.6	\$1,232.2	\$1,342.3	\$5,012.6
Change, yr/yr		29.8%	18.2%	2.4%	4.1%	1.8%	8.2%	2.8%	4.2%	4.8%	5.2%	5.8%	5.1%	5.2%	5.2%	5.5%	5.6%	5.6%	5.5%
Change, qtr/qtr					-7.3%	2.2%	-1.0%	9.6%		-5.5%	2.6%	-0.5%	8.9%		-5.5%	2.9%	-0.4%	8.9%	
Cost of sales	1,001.0	1,318.0	1,581.0	1,549.0	398.0	400.0	383.0	426.9	1,607.9	410.6	416.1	399.5	435.3	1,661.4	425.9	432.8	415.9	453.0	1,727.6
Gross Profit	1,759.0	2,264.0	2,652.0	2,787.0	692.0	714.0	720.0	782.4	2,908.4	731.6	756.0	767.0	835.6	3,090.0	775.5	803.8	816.3	889.3	3,284.9
Gross Margin	63.73%	63.20%	62.65%	64.28%	63.49%	64.09%	65.28%	64.70%	64.40%	64.05%	64.50%	65.75%	65.75%	65.03%	64.55%	65.00%	66.25%	66.25%	65.53%
SG&A	1,057.0	1,365.0	1,447.0	1,452.0	322.0	339.0	359.0	402.1	1,422.1	331.2	356.3	361.6	406.7	1,455.8	348.4	369.1	367.8	422.8	1,508.2
R&D	365.0	411.0	407.0	399.0	90.0	91.0	91.0	111.9	383.9	91.4	94.9	96.2	115.6	398.2	96.1	97.1	98.6	112.1	403.8
Amortization of intangibles	16.0	17.0	20.0	15.0	4.0	3.0	4.0	3.0	14.0	3.5	3.5	3.5	3.5	14.0	3.5	3.5	3.5	3.5	14.0
Restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other expenses/(income)	(1.0)	(25.0)	(28.0)	(21.0)	2.0	(3.0)	(7.0)	(5.0)	(13.0)	(7.0)	(7.0)	(7.0)	(7.0)	(28.0)	(8.0)	(8.0)	(8.0)	(8.0)	(32.0)
Total operating expenses	1,437.0	1,768.0	1,846.0	1,845.0	418.0	430.0	447.0	511.9	1,806.9	419.1	447.7	454.3	518.8	1,840.0	440.0	461.7	461.9	530.4	1,894.0
Adj. Operating Income	322.0	496.0	806.0	942.0	274.0	284.0	273.0	270.4	1,101.4	312.5	308.2	312.6	316.8	1,250.1	335.5	342.1	354.4	358.9	1,390.9
Adj. Operating Margin	11.67%	13.85%	19.04%	21.73%	25.14%	25.49%	24.75%	22.37%	24.39%	27.36%	26.30%	26.80%	24.93%	26.31%	27.92%	27.66%	28.77%	26.74%	27.75%
Interest expense	26.0	37.0	36.0	31.0	22.0	32.0	29.0	29.5	112.5	30.0	30.0	30.0	30.0	120.0	30.0	30.0	30.0	30.0	120.0
Income before taxes	296.0	459.0	770.0	911.0	252.0	252.0	244.0	240.9	988.9	282.5	278.2	282.6	286.8	1,130.1	305.5	312.1	324.4	328.9	1,270.9
Pretax Margin	10.72%	12.81%	18.19%	21.01%	23.12%	22.62%	22.12%	19.93%	21.90%	24.73%	23.74%	24.23%	22.56%	23.78%	25.43%	25.24%	26.33%	24.50%	25.35%
Income taxes	108.0	183.0	264.0	372.0	73.0	74.0	72.0	71.1	290.1	83.3	82.1	83.4	84.6	333.4	90.1	92.1	95.7	97.0	374.9
Tax Rate	36.49%	39.87%	34.29%	40.83%	28.97%	29.37%	29.51%	29.50%	29.33%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%
Net Income	188.0	276.0	506.0	539.0	179.0	178.0	172.0	169.9	698.9	199.1	196.2	199.2	202.2	796.7	215.4	220.0	228.7	231.9	896.0
less: net income attributable to noncont	(1.0)	1.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income attributable to Zoetis	189.0	275.0	503.0	539.0	179.0	178.0	172.0	169.9	698.9	199.1	196.2	199.2	202.2	796.7	215.4	220.0	228.7	231.9	896.0
Net Margin	6.85%	7.68%	11.88%	12.43%	16.42%	15.98%	15.59%	14.05%	15.47%	17.43%	16.74%	17.08%	15.91%	16.77%	17.93%	17.79%	18.56%	17.27%	17.87%
Diluted EPS	\$0.38	\$0.55	\$1.01	\$1.08	\$0.36	\$0.36	\$0.34	\$0.34	\$1.40	\$0.40	\$0.39	\$0.40	\$0.40	\$1.59	\$0.43	\$0.44	\$0.46	\$0.46	\$1.79
Diluted Shares	500.0	500.0	500.0	500.0	500.1	500.2	500.0	500.0	500.1	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0
Dividend			\$0.83	\$0.13	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26
Dividend yield					0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Payout			82.7%	11.7%	0.0%	18.5%	18.6%	19.1%	14.0%	16.3%	16.6%	16.3%	16.1%	16.3%	15.1%	14.8%	14.2%	14.0%	14.5%
Depreciation and amortization	103.0	122.0	137.0	137.0	35.0	38.0	37.0	39.3	149.3	37.7	38.7	38.5	41.9	156.8	39.6	40.8	40.7	44.3	165.4
Adjusted EBITDA	426.0	617.0	940.0	1,079.0	309.0	322.0	310.0	309.7	1,250.7	350.1	346.9	351.1	358.7	1,406.9	375.1	382.9	395.1	403.2	1,556.3
Adjusted EBITDA Margin	15.43%	17.23%	22.21%	24.88%	28.35%	28.90%	28.11%	25.62%	27.69%	30.66%	29.60%	30.10%	28.23%	29.61%	31.22%	30.96%	32.07%	30.04%	31.05%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	35.72%	36.51%	35.91%	34.72%	35.30%	35.60%	35.95%	35.50%	34.25%	34.25%	34.97%	35.45%	35.00%	33.75%	33.75%	34.47%
SG&A	38.30%	38.11%	34.18%	33.49%	29.54%	30.43%	32.55%	33.25%	31.49%	29.00%	30.40%	31.00%	32.00%	30.64%	29.00%	29.85%	29.85%	31.50%	30.09%
R&D	13.22%	11.47%	9.61%	9.20%	8.26%	8.17%	8.25%	9.25%	8.50%	8.00%	8.10%	8.25%	9.10%	8.38%	8.00%	7.85%	8.00%	8.35%	8.06%
Total operating expenses	52.07%	49.36%	43.61%	42.55%	38.35%	38.60%	40.53%	42.33%	40.01%	36.69%	38.20%	38.95%	40.82%	38.72%	36.63%	37.34%	37.48%	39.51%	37.79%
Depreciation and amortization	3.73%	3.41%	3.24%	3.16%	3.21%	3.41%	3.35%	3.25%	3.31%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%
Yr/Yr Growth:																			
Cost of Sales		31.7%	20.0%	-2.0%	2.6%	4.7%	8.8%	0.0%	3.8%	3.2%	4.0%	4.3%	2.0%	3.3%	3.7%	4.0%	4.1%	4.1%	4.0%
Gross Profit		28.7%	17.1%	5.1%	5.0%	0.3%	7.9%	4.5%	4.4%	5.7%	5.9%	6.5%	6.8%	6.2%	6.0%	6.3%	6.4%	6.4%	6.3%
SG&A		29.1%	6.0%	0.3%	-2.7%	-3.4%	8.8%	-8.6%	-2.1%	2.9%	5.1%	0.7%	1.1%	2.4%	5.2%	3.6%	1.7%	4.0%	3.6%
R&D		12.6%	-1.0%	-2.0%	-3.2%	0.0%	-3.2%	-7.6%	-3.8%	1.5%	4.3%	5.8%	3.4%	3.7%	5.2%	2.3%	2.4%	-3.1%	1.4%
Adjusted Operating Income		54.0%	62.5%	16.9%	15.6%	3.6%	9.6%	48.6%	16.9%	14.0%	8.5%	14.5%	17.1%	13.5%	7.4%	11.0%	13.4%	13.3%	11.3%
Income before taxes		55.1%	67.8%	18.3%	10.0%	-5.3%	0.8%	38.5%	8.6%	12.1%	10.4%	15.8%	19.0%	14.3%	8.2%	12.2%	14.8%	14.7%	12.5%
Net income attributable to Zoetis		45.5%	82.9%	7.2%	17.8%	1.1%	11.7%	198.0%	29.7%	11.2%	10.2%	15.8%	19.0%	14.0%	8.2%	12.2%	14.8%	14.7%	12.5%
Diluted EPS		45.5%	82.9%	7.2%	17.7%	1.1%	11.7%	198.0%	29.6%	11.3%	10.2%	15.8%	19.0%	14.0%	8.2%	12.2%	14.8%	14.7%	12.5%

Source: Company reports and Piper Jaffray & Co. Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

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N: Neutral  
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Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	347	58.32	74	21.33
HOLD [N]	225	37.82	16	7.11
SELL [UW]	23	3.87	1	4.35

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## **Analyst Certification — Kevin K. Ellich, Sr Research Analyst** **— Bradley D. Maiers, Research Analyst**

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