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Equity Research

Zoetis, Inc.

(ZTS - $33.40)

April 1, 2013

Company Update | Note

Medical Devices & Supplies

Strong Buy
$41.00

Trading Data:

Last Price (3/28/2013)	$33.40
52–Week High (3/14/2013)	$35.42
52–Week Low (2/01/2013)	$30.47
Market Cap. (MM)	$16,700
Shares Out. (MM)	500
3 Month Avg. Daily Vol. (MM)	3.887

Earnings Estimates: ($ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY14E	0.35	0.40	0.37	0.38	1.50
FY13E	0.30	0.35	0.32	0.33	1.30
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	25.7	22.3	27.3
EV / EBITDA	15.6	13.6	16.4
EV / Rev.	4.3	3.9	4.7

Source: CL King & Associates estimates

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See required disclosures at the end of report.

10-K Filing Provides Some Useful Data

- Zoetis filed its 10-K late in the afternoon on Thursday, March 28. The filing is particularly significant as it is the first meaningful release of information since the IPO.
- We believe the information in the 10-K is consistent with our expectations and supportive of our assumptions underlying our financial forecasts.
- The 2012 financial results provided in the 10-K enable us to estimate the December quarter (Q4) results excluding unusual items. Based on our computations, adjusted Q4 EPS were below our estimate, but we do not view the difference as material.
- Moreover, we believe investors are much more focused on the March quarter results and associated management commentary scheduled for April 30.
- We are maintaining our forecasts and we reiterate our Strong Buy rating.

10-K filing is the first meaningful release of information since the IPO: Late Thursday afternoon, March 28, Zoetis filed its 2012 10-K. The filing is particularly noteworthy because the company had not previously disclosed its December quarter (Q4) results, and this is the company's first major information release since the completion of the IPO on January 31.

We view the information in the 10-K as supportive of our forecasts: Based on our review, we believe information contained in Zoetis' 2012 10-K filing is consistent with our expectations and supportive of the assumptions underlying our 2013 and 2014 revenue and EPS projections. We continue to project organic revenue growth of approximately 4.5% in 2013 and approximately 7% in 2014. Importantly, we project Zoetis should achieve meaningful expansion in its operating profit margin in both years, and that the company's future income tax rates should be significantly below historical levels.

10-K enables us to estimate Q4 results excluding unusual items: In addition, using the full-year 2012 financial results and other disclosures provided in the 10-K, we were able to compute an estimate of the company's Q4 financial results excluding unusual items. Importantly, we do not believe the Q4 financial results are overly meaningful for investors as Zoetis was still 100% owned by Pfizer (PFE: NR) during Q4 and we believe the company was placing significant focus on the IPO process. We think investors are much more focused on Zoetis' upcoming March quarter (Q1) results and associated management commentary, as well as expectations for the full year 2013. Zoetis is scheduled to report its Q1 results on Tuesday, April 30.

Nevertheless, we provide a review of our interpretation of Zoetis' Q4 results compared to our estimates prior to the release of the 10-K. We note our estimates of the Zoetis Q4 results exclude items we consider unusual or one-time in nature, and we also exclude expenses associated with the amortization of intangibles from our EPS computations.

Q4 revenues were very similar to our estimate, though Pfizer's Q4 results had already provided a clear picture: Zoetis' reported Q4 revenues were $1,176MM compared to our estimate of $1,171MM and $1,127MM last year. We note that within its Q4 earnings release on January 29, Pfizer had already disclosed that its Animal Health segment revenues were $1,171MM and that the organic revenue growth of its Animal Health segment was 8% in Q4. The animal health segment reported by Pfizer is not the same as the Zoetis business, but the difference between the two is very slight. Accordingly, the Pfizer Q4 results had already provided a very clear view of the Zoetis Q4 revenue results.

Also, we note that the 10-K disclosed Zoetis' full-year 2012 organic revenue growth was 5%. This is slightly different than the full-year organic growth of 6% that Pfizer had already reported for its Animal Health segment in 2012. However, we believe the difference between these two figures is probably very slight and due to rounding.

GAAP results for Q4 and full-year 2012 are not especially meaningful: Based on disclosures in the 10-K, on a GAAP basis Zoetis' Q4 EPS were a loss of $0.02, and that 2012 GAAP EPS were $0.87. Within the 10-K the company also disclosed that based on its computations that 2012 adjusted EPS excluding unusual items were $1.08.

Based on our computations, adjusted Q4 EPS were below our estimate: However, excluding unusual items and expenses related to the amortization of intangibles, based on the full-year 2012 financial results provided in the 10-K combined with previous financial disclosures for the first three quarters of 2012, we estimate Zoetis' adjusted Q4 EPS were approximately $0.12. Yet based on our calculations Zoetis had an unusually high income tax rate in Q4, even after excluding the unusual items we were able to identify. Assuming the same 34.5% income tax rate we had included in our financial model, we estimate the company's adjusted EPS would have been approximately $0.24 in Q4 and that the 2012 adjusted EPS would have been about $1.20. These figures compare to our projections of $0.29 and $1.24 prior to the filing of the 10-K.

The difference in Q4 was due to higher cost of sales and SG&A than we projected: The adjusted Q4 EPS result was below our estimate due to higher cost of sales as a percentage of revenues and higher SG&A as a percentage of revenues than we were projecting. A summary of the actual results (based on our computations from the 10-K and other documents), our estimates and 4Q11 is shown in Table 1 below. While the margins were not as good as we projected, we do not think the difference is meaningful, and we doubt it signals a trend. As mentioned earlier, Zoetis was still 100% owned by Pfizer in the December quarter and we believe much of the company's focus was on the IPO process during that period. We continue to project the company's operating profit margin should expand significantly over the next several years. The income tax rate should also be much lower than historical levels over the next several years. Additional details are provided in our March 11, 2013, initiation report.

Table 1: Zoetis Q4 Margin Comparisons

Item	CL King's Forecast Q4:12E	Adjusted Q4:12A	Q4:11A
As a precentage of revenues:			
Cost of goods sold	35.0%	36.3%	35.1%
SG&A	36.0%	37.4%	37.5%
Research & development	9.8%	10.3%	9.8%
Amortization of intangible assets	1.4%	1.4%	1.6%
Operating expenses	82.2%	85.4%	84.0%
Operating income	17.8%	14.6%	16.0%

Source: 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. It 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.

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Table 2: Valuation Multiples for Zoetis

Item	2012PF	2013E	2014E
Stock price	$33.40	$33.40	$33.40
Revenues (in 1,000's)	$4,336,000	$4,561,473	$4,873,801
EBITDA (in 1,000's)	$1,105,000	$1,258,830	$1,405,428
EPS - GAAP	$1.01	$1.21	$1.41
EPS adj to add back amortization exp.	**$1.08**	**$1.30**	**$1.50**
P / E ratio - based on adj. EPS	**31.0 x**	**25.7 x**	**22.3 x**
EV / EBITDA ratio	**18.0 x**	**15.6 x**	**13.6 x**
EV / Revenue ratio	**4.6 x**	**4.3 x**	**3.9 x**
ROA	9.2%	10.6%	12.1%
ROE	22.2%	47.7%	39.5%
Enterprise value computation:			
Equity market value (in 1,000's)	$16,700,000	$16,969,046	$17,139,374
Total debt (in 1,000's)	$3,640,000	$3,340,000	$2,540,000
Cash (in 1,000's)	$484,000	$710,187	$522,007
Enterprise value (in 1,000's)	$19,856,000	$19,598,859	$19,157,367

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 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.*

We anticipate Pfizer should eventually distribute its 80% ownership position in Zoetis to Pfizer shareholders. This could result in significant sales of Zoetis stock on the open market, which could cause Zoetis' stock price to decline.

Previous research update - March 11, 2013

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DISCLOSURES:

ANALYST CERTIFICATION

I, Ross Taylor, certify that all views expressed by me in this research report regarding the securities, as named herein, and its issuers accurately reflect my personal views. I further certify that I have not and will not receive compensation directly or indirectly related to any specific recommendations or views expressed in this research report.

Additional information available upon request.

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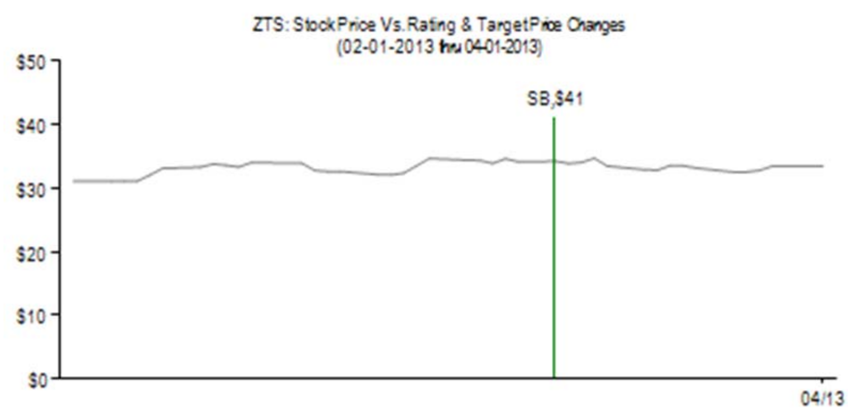
RATINGS INFORMATION

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.	18.98%	0.73%	1.46%
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.	37.23%	1.46%	0.73%
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.	42.34%	0.73%	1.46%
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.	1.46%	0.00%	0.00%

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