

# Zoetis, Inc.

(ZTS - \$30.80)

June 17, 2013

**Company Update** **Note**

## Medical Devices & Supplies

**Strong Buy**  
**\$41.00**

### Trading Data:

Last Price (6/14/2013)	\$30.80
52-Week High (3/14/2013)	\$35.42
52-Week Low (4/24/2013)	\$30.42
Market Cap. (MM)	\$15,400
Shares Out. (MM)	500.0
3 Month Avg. Daily Vol. (MM)	2.993

### Earnings Estimates: (\$ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY14E	0.35	0.40	0.37	0.38	1.50
FY13E	0.36A	0.35	0.32	0.33	1.36
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	22.6	20.5	27.3
EV / EBITDA	14.2	12.7	16.4
EV / Revs.	4.0	3.6	4.7

Source: CL King & Associates estimates

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See required disclosures at the end of report.

## We Recommend Buying Stock on Weakness since Exchange Offer Announced

- Zoetis' stock has declined 7% since Pfizer announced its exchange offer on May 22. We do not believe fundamentals have changed. Instead, we believe arbitrage-related selling has caused most of the decline in the stock since then.
- We note 116% of the float has traded since May 22, and the average trading volume over this 17-day period is 3.6 higher than the average trading volume between the second day following the IPO and May 21.
- On Friday after the close, S&P Dow Jones announced Zoetis would be added to the S&P 500 after the close of trading on June 21.
- We recommend fundamental investors take advantage of the recent weakness in Zoetis' stock. Even Friday's announcement pushes the stock up some; we believe the stock is very attractive in the low \$30s. We reiterate our Strong Buy rating.

**Zoetis stock has declined 7% since Pfizer announced the exchange offer on May 22:** Zoetis stock has declined from \$33.04 to \$30.80 since Pfizer (PFE: NR) announced the exchange offer on the morning of May 22, 2013. This 6.8% decline in Zoetis compares to a 2.5% decline in the S&P 500 index over the same period. The exchange offer expires at midnight on June 19.

**We believe arbitrage related selling has caused most of the decline:** We do not think the fundamental outlook for Zoetis has changed since May 22. Instead, we believe the majority of the decline in the stock has been driven by arbitrage-related selling, as arbitrage investors seek to take advantage of the discount Pfizer intends to provide to its shareholders that tender for Zoetis stock.

As support for our view that significant arbitrage-related selling has taken place since Pfizer announced the exchange offer on May 22, we note that 114 million Zoetis shares, or 116% of the float, have traded over the last seventeen trading days (i.e., the time period since Pfizer announced the exchange offer). In addition, the average daily trading volume over the last seventeen days was 6.7 million shares. This is 3.6 times higher than the average daily trading volume of 1.9 million shares between February 4, the second trading day following the IPO, and May 21. Trading volume data is shown in Table 1, below.

**We suggest buying on the recent weakness, even if Friday's announcement that Zoetis will be added to the S&P 500 pushes the stock up some:** We view

the current valuation of Zoetis as attractive, and we encourage fundamental investors to take advantage of the recent weakness to buy the stock. After the close of trading on Friday S&P Dow Jones announced Zoetis would be added to the S&P 500 index after the close of trading on Friday, June 21. This caused Zoetis' stock to trade up 1.04% after hours on Friday. Even if the stock strengthens a little more this morning as a result of Friday's news, we still think Zoetis' stock represents a very attractive value anywhere in the low \$30s.

Table 1: Zoetis Daily Trading Volume History

<u>Trading Date</u>	<u>Trading Volume</u>	<u>Average Daily Volume</u>	<u>Percent of Float</u>
6/14/2013	10,665,000		11%
6/13/2013	5,849,800		6%
6/12/2013	7,648,500		8%
6/11/2013	6,367,500		6%
6/10/2013	4,992,100		5%
6/7/2013	5,134,200		5%
6/6/2013	2,918,200		3%
6/5/2013	3,522,300		4%
6/4/2013	4,513,400		5%
6/3/2013	3,398,000		3%
5/31/2013	6,512,400		7%
5/30/2013	3,934,100		4%
5/29/2013	3,095,700		3%
5/28/2013	4,960,300		5%
5/24/2013	5,911,600		6%
5/23/2013	9,008,500		9%
5/22/2013	26,006,000		26%
Subtotal, May 22 to June 14	114,437,600	6,731,624	116%
Subtotal, Feb. 4 to May 21	140,217,800	1,869,571	

Source: Yahoo! Finance and CL King & Associates estimates

**Exchange ratio will be determined over the next three trading days:** We note the relative share prices of Zoetis and Pfizer caused the "upper limit" of 0.9898 shares of Zoetis stock per share of Pfizer stock to be reached on Friday for the first time. If this upper limit of 0.9898 is reached during the three trading days (June 17, 18, and 19) on which the exchange ratio will be determined, the discount at which tendering shareholders will receive their Zoetis stock will decline from the maximum discount level of 7%.

**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. 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. 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	\$30.80	\$30.80	\$30.80
Revenues (in 1,000's)	\$4,336,000	\$4,562,840	\$4,878,018
EBITDA (in 1,000's)	\$1,105,000	\$1,281,428	\$1,406,543
EPS - GAAP	\$1.01	\$1.29	\$1.42
EPS adj to add back amortization exp.	\$1.08	\$1.36	\$1.50
P/E ratio - based on adj. EPS	28.6 x	22.7 x	20.5 x
EV / EBITDA ratio	16.8 x	14.2 x	12.7 x
EV / Revenue ratio	4.3 x	4.0 x	3.6 x
ROA	9.2%	11.0%	12.0%
ROE	22.2%	49.2%	38.7%
Enterprise value computation:			
Equity market value (in 1,000's)	\$15,400,000	\$15,648,103	\$15,805,171
Total debt (in 1,000's)	\$3,640,000	\$3,340,000	\$2,540,000
Cash (in 1,000's)	\$484,000	\$730,552	\$544,019
Enterprise value (in 1,000's)	\$18,556,000	\$18,257,551	\$17,801,152

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. To begin, 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. The company may not be as effective as we project in managing its operations and expenses during its process of fully separating from Pfizer.

*There is a risk the pending exchange offer in which Pfizer shareholders can exchange their Pfizer shares for shares of Zoetis could cause volatility in the stock.*

*Previous research update – May 22, 2013*

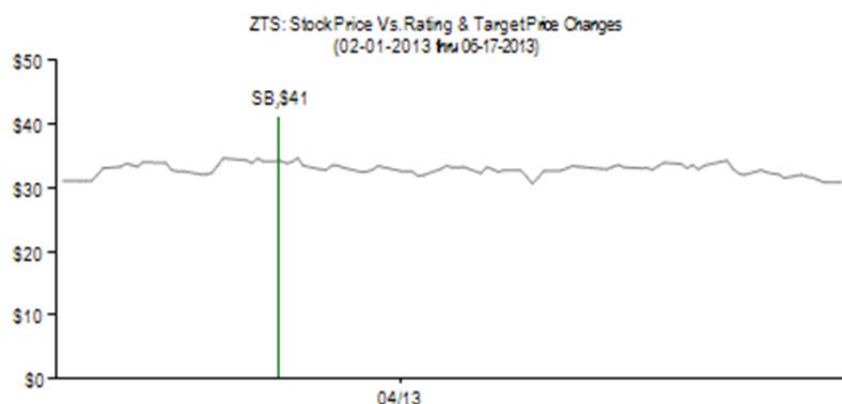
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*Additional information available upon request.*

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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: [www.ResearchMaestro.net](http://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
<b>Strong Buy (SB)</b>	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.	16.55%	0.00%	2.16%
<b>Buy (B)</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.	38.85%	1.44%	0.72%
<b>Neutral (N)</b>	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.	43.88%	0.72%	2.16%
<b>Sell (S)</b>	Analyst expects the stock price to decline 10% or more over the next 6-12 months and to underperform the broader market averages.	0.72%	0.00%	0.00%

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