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Healthcare | U.S. Major Pharmaceuticals

13 March 2013

Zoetis Inc.

Mature and fully valued, yet still a live stock in the Animal Health industry

Up 30% from the offering price of $26; macros and bias towards spin-out stories drive optimism. Zoetis, with ~$4.3bn in sales in 2012, is the global leader in the $23bn animal health market, which includes medicines and vaccines for livestock as well as companion animals. Having existed within Pfizer since the 1950's, Zoetis' stock debuted on 2/1/2013 at $31.50, up 21% from the IPO price of $26. Since then, the stock has risen ~30% to $33.82 at the close of 3/12/13 (vs. +3% SPX). We believe this stock performance reflects the market's optimism for the long-term industry outlook and a positive bias towards spin-out stories.

Upside to 2013 may be deterred by bearish macros. The animal health industry may see slower growth in 2013 with macro headwinds: droughts and rising feed costs constraining livestock production, and spending on companion animals feeling the squeeze from the prolonged recession. In the first 9 months of 2012, Zoetis' base revenue growth of 5% (6% U.S., flat EU, 4% Canada/Latin America, and 8% APAC) was weaker than the 7% base growth in 2010 and 2011. For 2013, we project 4.5% YOY revenue growth to $4.53bn and EPS of $1.40. Upside to estimates may be capped as environmental and economic headwinds are likely to linger through 2013.

Initiating at Equal Weight with a $35 PT; rich valuation leaves little room for error. We initiate on ZTS with an Equal Weight rating as the current stock price looks fully valued. Our DCF analysis yields a PT of $35 (25x FY13E EPS and 16x EV/EBITDA). A P/E above 20x likely warrants double-digit EPS growth, in our view. With a base CAGR of 5% (2011-20E), on pace with the industry, Zoetis will likely depend on acquisitions to outpace the sector. While there is headroom for EBIT improvement, management has not laid out concrete plans for leverage delivery. The current valuation and low dividend payout ratio (19%) leave little room for missteps, in our view.

ZTS: Quarterly and Annual EPS (USD)

	2012	2013			2014			Change y/y	
FY Dec	Actual	Old	New	Cons	Old	New	Cons	2013	2014
Q1	N/A	N/A	0.34E	N/A	N/A	0.37E	N/A	N/A	9%
Q2	N/A	N/A	0.36E	N/A	N/A	0.41E	N/A	N/A	14%
Q3	N/A	N/A	0.35E	N/A	N/A	0.40E	N/A	N/A	14%
Q4	N/A	N/A	0.35E	N/A	N/A	0.43E	N/A	N/A	23%
Year	N/A	N/A	1.40E	1.46E	N/A	1.61E	1.62E	N/A	15%
P/E	N/A		24.2			21.0			

Source: Barclays Research.

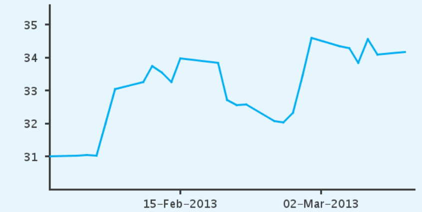
Consensus numbers are from Thomson Reuters

Stock Rating	EQUAL WEIGHT from N/A
Industry View	POSITIVE Unchanged
Price Target	USD 35.00 from N/A
Price (12-Mar-2013)	USD 33.82
Potential Upside/Downside	+3%
Tickers	ZTS

Market Cap (USD mn)	17090
Shares Outstanding (mn)	500.00
Free Float (%)	84.95
52 Wk Avg Daily Volume (mn)	4.5
Dividend Yield (%)	N/A
Return on Equity TTM (%)	11.17
Current BVPS (USD)	2.09

Source: FactSet Fundamentals

Price Performance	Exchange-NYSE
52 Week range	USD 34.89-30.47



Link to Barclays Live for interactive charting

U.S. Major Pharmaceuticals

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PLEASE SEE ANALYST(S) CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 33.

U.S. Major Pharmaceuticals | **Industry View: POSITIVE**

Zoetis Inc. (ZTS)

Stock Rating: EQUAL WEIGHT

Income statement ($mn)	2012A	2013E	2014E	2015E	CAGR
Revenue	N/A	4,527	4,790	5,089	N/A
EBITDA (adj)	N/A	1,291	1,452	1,561	N/A
EBIT (adj)	N/A	1,145	1,306	1,447	N/A
Pre-tax income (adj)	N/A	1,034	1,199	1,345	N/A
Net income (adj)	N/A	733	847	951	N/A
EPS (adj) ($)	N/A	1.40	1.61	1.80	N/A
Diluted shares (mn)	N/A	525.0	525.0	525.0	N/A
DPS ($)	N/A	0.26	0.31	0.37	N/A

Margin and return data					Average
EBITDA (adj) margin (%)	N/A	28.5	30.3	30.7	29.8
EBIT (adj) margin (%)	N/A	25.3	27.3	28.4	27.0
Pre-tax (adj) margin (%)	N/A	22.8	25.0	26.4	24.8
Net (adj) margin (%)	N/A	16.2	17.7	18.7	17.5
ROIC (%)	N/A	18.7	16.4	18.6	17.9
ROA (%)	N/A	11.6	11.5	12.1	11.7
ROE (%)	N/A	26.8	38.7	37.6	34.4

Balance sheet and cash flow ($mn)					CAGR
Tangible fixed assets	N/A	4,835	5,516	6,016	N/A
Intangible fixed assets	N/A	1,878	1,859	1,841	N/A
Cash and equivalents	N/A	904	1,393	1,832	N/A
Total assets	N/A	6,713	7,376	7,857	N/A
Short and long-term debt	N/A	3,650	3,650	3,650	N/A
Other long-term liabilities	N/A	557	557	557	N/A
Total liabilities	N/A	5,182	5,185	5,331	N/A
Net debt/(funds)	N/A	2,746	2,257	1,818	N/A
Shareholders' equity	N/A	1,531	2,191	2,526	N/A
Change in working capital	N/A	538	636	-78	N/A
Cash flow from operations	N/A	647	823	1,163	N/A
Capital expenditure	N/A	-170	-170	-127	N/A
Free cash flow	N/A	477	653	1,036	N/A

Valuation and leverage metrics					Average
P/E (adj) (x)	N/A	24.2	21.0	18.8	21.3
EV/EBITDA (adj) (x)	N/A	15.2	13.2	12.0	13.5
P/BV (x)	N/A	N/A	N/A	N/A	N/A
Dividend yield (%)	N/A	0.8	0.9	1.1	0.9
Total debt/capital (%)	N/A	70.4	62.5	59.1	64.0

Selected operating metrics				
SG&A/sales (%)	N/A	31.1	30.0	29.5
R&D/sales (%)	N/A	8.7	8.5	8.3
R&D growth (%)	N/A	-2.3	3.2	3.3
SG&A growth (%)	N/A	-0.4	2.2	4.4

Price (12-Mar-2013)	USD 33.82
Price Target	USD 35.00

Why Equal Weight? Zoetis' current stock price appears fairly valued in our view. Macro headwinds for both the livestock and companion animal sectors will likely limit upside to 2013 earnings. Long-term growth will likely depend on Zoetis' ability to leverage it vast global portfolio to outpace industry growth. Our price target reflects 25x 2013E EPS.

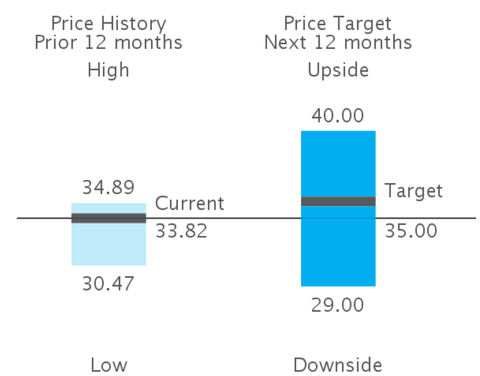
Upside case USD 40.00

Our upside case assumes a strong recovery of the global animal health market in 2013/14 to 6%-7% per year, and Zoetis achieving an EBIT margin expansion to 30%+ in the longer term. These factors should drive an upside case of $40 or 29x 2013E EPS.

Downside case USD 29.00

Our downside case assumes the stagnation of the global animal health market in 2013/14. Zoetis' growth is on pace with a soft industry outlook, and EBIT margin improves to 27% in the longer term. These factors should lead to a downside case of $29 or 21x 2013E EPS.

Upside/Downside scenarios



Source: Company data, Barclays Research
Note: FY End Dec

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Company Profile

Zoetis (NYSE: ZTS) is a global animal health company that focuses on the discovery, development, manufacturing, and commercialization of veterinary medicines and vaccines. The company's portfolio includes more than 300 product lines across for livestock animals and companion animals. There are fives major product categories: vaccines, parasiticides, anti-infectives, medicinal feed additives, and other pharmaceutical products. These products are sold in more than 120 countries, and the company has local presence in ~70 countries. Key end market consumers include livestock producers, veterinarians, and companion animal owners. At the end of fiscal year 2011, the company generated $4.2B in revenues. There are ~9,500 total employees, and the sales organization has ~3,400 employees.

Separation history: Zoetis had been a business unit of Pfizer since 1952, and it initiated its initial public offering on the NYSE on Feb 1, 2013 with a price of $26 per share and with 99.015mn shares, which accounts for 19.8% of the company. The remaining shares are still owned by Pfizer, accounting for 80.2% of the total outstanding shares.

Investment Thesis

Can a mature player sustain a growth rate that outpaces the sector?

We view Zoetis as a mature, global animal health company, which has a dominant industry market share of ~19%. The company has a long history of acquisitions and portfolio integration. In 2011, acquisitions added nearly $1bn in sales to Zoetis (~24% of total revenues); the key contributors were the Fort Dodge Animal Health operation from Wyeth in 2009 and Alpharma with the King Pharmaceuticals acquisition in 2011. We believe that the key investor focus should be on whether Zoetis will be able to leverage its vast global portfolio to sustain a growth rate above industry while simultaneously improving margins.

Rich valuation leaves little room for further upside

We initiate coverage of Zoetis with an Equal Weight rating (Industry View: Positive) and a price target of $35. Our $35 PT is driven by our DCF analysis assuming a 7% discount rate and a 2.5% terminal growth rate. Our price target of $35 represents a 25x P/E and a 16x EV/EBITDA. The current stock price of $33.82 looks fully valued at 24x P/E and a 15x EV/EBITDA multiple. Companies within the healthcare sector with similar multiples tend to have high-single-digit revenue growth and double-digit EPS growth, which, to us, represent high hurdles for a mature company. Long-term macro trends for the animal health industry appear positive (consulting firm Vetnosis estimates a 5.7% CAGR from 2011A to 2015E), but we remain cautious about whether 1) Zoetis can outpace industry growth rate, and 2) near-term sector stagnation will derail the sector's long-term growth trajectory. Zoetis will likely need to 1) continue to supplement its mature portfolio with inorganic opportunities to boost growth, and/or 2) improve its payout ratio from the current 19% level to maintain investor interest in the longer term.

Scenario analysis based on a range of growth trajectories

In Figure 1, we provide a scenario analysis of Zoetis' DCF valuation with a range of differing assumptions for overall animal health industry growth trends. Our price target of $35 reflects our base case expectations for a 5%-6% sector growth rate over the next decade. Should the market stagnate at 4%-5%, we project a downside to $29 (21x FY2013E EPS) and a peak margin potential at 27%. If the sector delivers a robust recovery to 6%-7% growth, we estimate an upside case of $40 (29x FY2013e EPS) and peak margins above 30%.

FIGURE 1

Scenario analysis for Zoetis' growth trajectory based on macro growth rate of the industry as a whole

	Revenue CAGR					EBIT CAGR			DCF
	AH market CAGR (2011A-2020E)	2011A-2016E	2016E-2020E	2011A-2020E	Peak EBIT Margin	2011A-2016E	2016E-2020E	2011A-2020E	
Upside Case	6% to 7%	5.6%	7.6%	6.5%	31%	16%	9%	12%	$ 40
Base Case	5% to 6%	5.0%	5.7%	5.3%	29%	14%	6%	10%	$ 35
Downside Case	4% to 5%	3.9%	4.9%	4.3%	27%	11%	5%	8%	$ 29

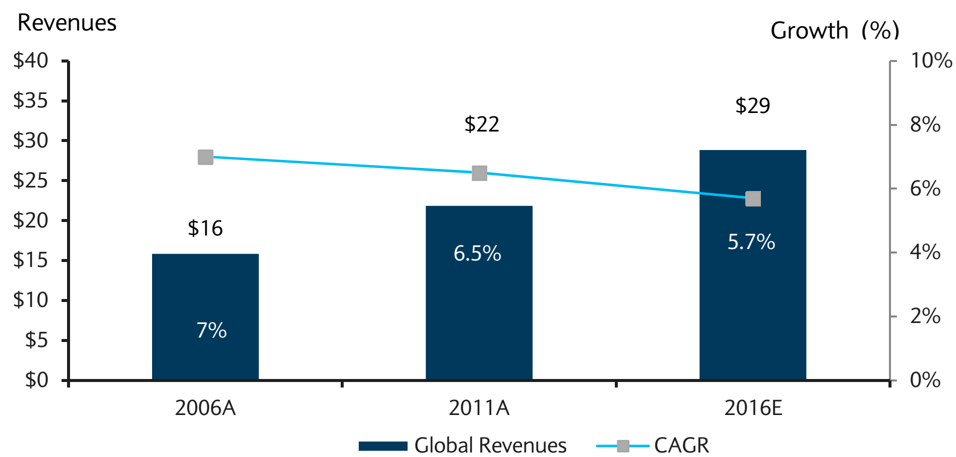
Source: Company Reports; Barclays Research.

Market Overview

The global animal health market generated ~$22bn in annual sales in 2011. Vetnosis – a consulting firm specializing in the animal health market – projected that the industry will grow at a 5.7% CAGR between 2011A and 2016E (Figure 2). Key growth drivers include global population growth (from 5.9bn in 2010 to 8.0bn in 2025 according to United Nations projections), economic development and increases in disposable income particularly in emerging markets, increased consumption of animal protein products (Figure 4), livestock industry productivity improvements, and increased ownership and medicalization of companion animal care. There are five key product lines – medicines, vaccines, medicinal feed additives, parasiticides, and other - for two major groups of animals: companion animals and food-producing or livestock animals. In Figure 3, we present the industry growth trends by geographic regions and species as projected by Vetnosis. Not surprisingly, the high-single-digit growth of Asia/Pacific and Canada/Latin America surpasses the mid-single-digit expectations for the developed markets in the U.S. and Europe.

FIGURE 2

Global Animal Health Medicines & Vaccines Revenues ($bn) – Historical and projected



Source: Vetnosis; Global revenues in billions of USD.

FIGURE 3

Vetnosis projected global animal health market growth by geographic regions and species

	2011A	2016E	CAGR (%)
Geographic distribution			
US	6.49	8.08	4.5%
EuAfME	7.47	9.26	4.4%
APAC	3.69	5.40	7.9%
CLAR	4.25	6.25	7.5%
Species distribution			
Companion Animals	8.9	11.4	5%
Livestock	13.1	17.6	6%
Total	22	28.99	5.7%

Source: Vetnosis; Global revenues in billions of USD. EuAfMe = Europe/Africa/Middle East, CLAR = Canada/Latin America, APAC – Asia/Pacific.

FIGURE 4

Current and potential global animal protein consumption (millions of metric tons)

	Meat Consumption			Milk Consumption		
	2003A	2050E	CAGR	2003A	2050E	CAGR
Developed countries	107	119	0.2%	249	275	0.2%
Asia	100	301	2.4%	157	558	2.7%
Other developing countries	43	161	2.8%	72	291	3.0%
Total	250	581	1.8%	478	1124	1.8%

Source: USDA World Markets Livestock and Poultry, FAO the State of Food and Agriculture Report. Barclays Research.

Zoetis Overview: Well balanced, mature player; acquisitions likely key to long-term growth

How does Zoetis compare with other large players in terms of top-line growth?

Zoetis is the only public, pure-play animal health company with annual sales above $1bn today (Figure 6). Six of out the top seven animal health players exist as business units of much bigger, diversified health care companies, and the next largest pure-play animal heath company, Virbac, produced ~€695mn in sales in 2012, making it only one-fifth of Zoetis' size by sales. A key investor concern will be whether Zoetis, already a dominant and mature player, will be able to gain further share and outpace the industry's average growth rate.

FIGURE 5

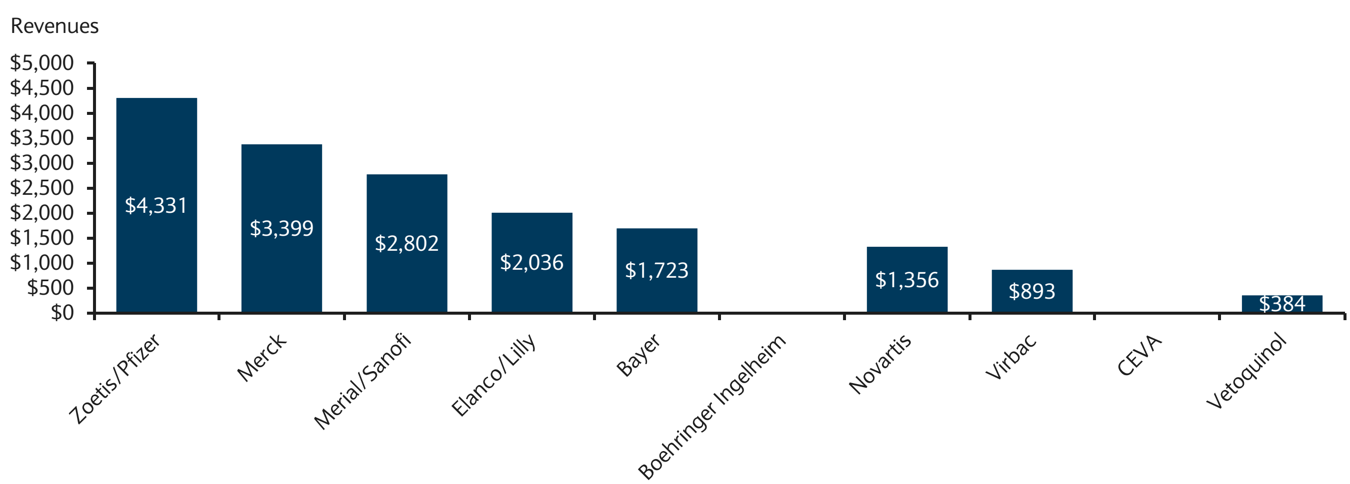
Comparison of YOY revenue growth rates of top 10 animal health players

	YOY Growth (%)			
Companies	**2010**	**2011**	**2012**	**CAGR (09A-12A)**
Top 10 players - Total Sales	15%	13%	NA	NA
Zoetis/Pfizer	30%	18%	2%	16%
Merck	8%	11%	4%	8%
Merial/Sanofi	8%	2%	7%	6%
Elanco/Lilly	15%	21%	21%	19%
Bayer	15%	6%	13%	11%
Boehringer Ingelheim	51%	6%	NA	NA
Novartis	10%	8%	4%	7%
Virbac	23%	9%	12%	14%
CEVA	19%	14%	NA	NA
Vetoquinol	12%	1%	5%	6%

Source: Company Reports; Barclay Research; all growth rates YOY calculated in local currencies. NA = Not available.

FIGURE 6

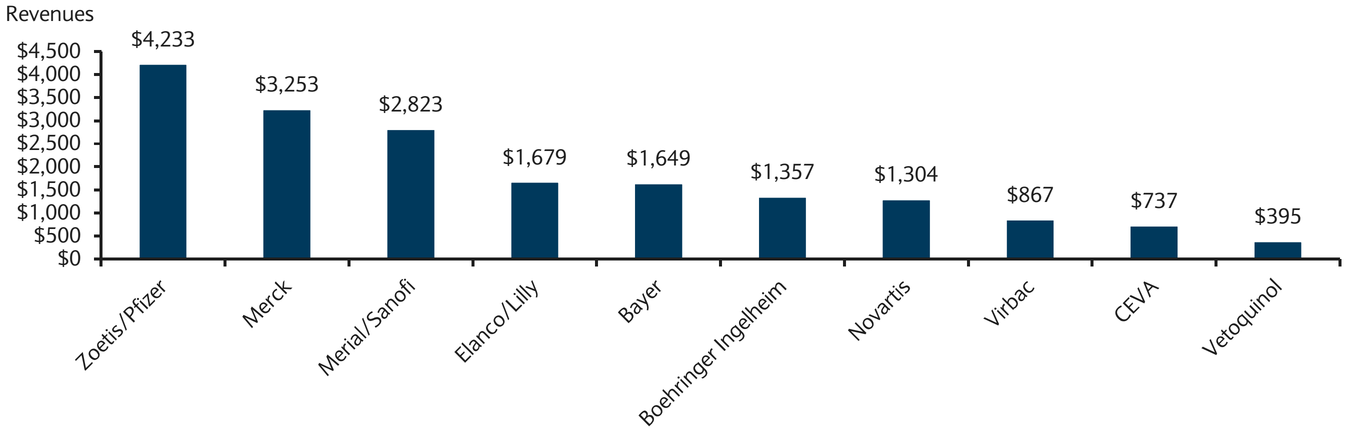
2012 Revenues for top 10 animal health companies($mn)



Source: Company Reports; Vetnosis. All revenues values converted into USD based on the average EURO/USD exchange rate of 1.286 in 2012. 2012 sales for Boehringer Ingelheim and CEVA are currently not available.

FIGURE 7

2011 Revenues for top 10 animal health companies



Source: Company Reports; Vetnosis. All values in millions of USD.

Competition for inorganic growth opportunities likely to continue

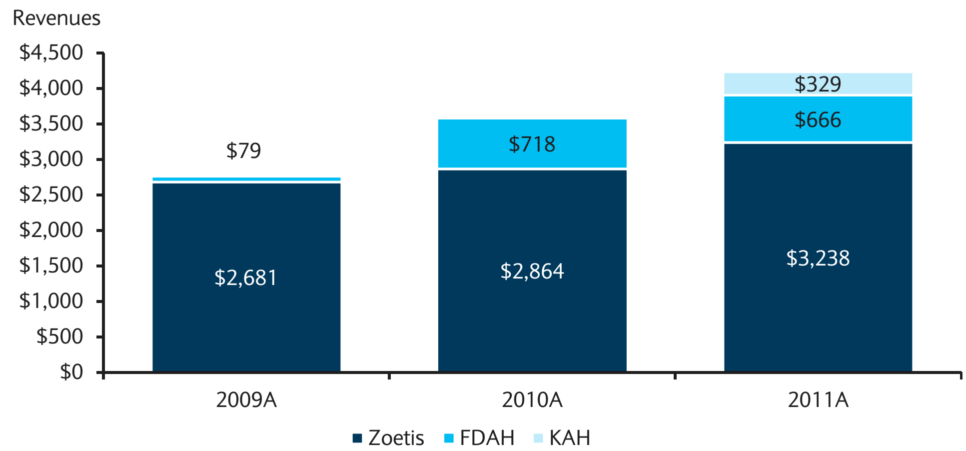
Two major acquisitions provided momentum to Zoetis' growth during the past three years. Figure 5 presents the top 10 players' recent revenue growth rates. In 2010 and 2011, Zoetis' revenue growth rates exceeded those of the top 10 players collectively, and we believe that the contributions from two major acquisitions – the Fort Dodge franchise from Wyeth and the Alpharma unit of King Pharmaceuticals – drove the performance (Figure 8). The base franchise grew by 7% in both 2010 and 2011, and acquisitions added 23% to growth in 2010 and 9% to growth in 2011. In 2011, the two major acquisitions contributed $995mn in revenues, or ~24% of total Zoetis sales. We believe that Zoetis, like other mature animal health players and human pharma counterparts, will continue to compete for inorganic growth opportunities to supplement their portfolio growth.

The first 9 months of 2012 saw a softening of the livestock sector across major geographies

Zoetis' base growth in 2012 is~5%, or slightly down from the previous two years. During the first 9 months of 2012, we observed a modest softening in base growth rates for Zoetis' operations across major geographies (base growth excludes the impact of acquisitions, divestitures, and foreign exchange). U.S. base growth has fallen from 13% in 2010, 7% in 2011, to 6% for the first three quarters of 2012 (Figure 9). Similar pauses in growth are observed in Asia/Pacific (APAC) as well as Canada/Latin America (CLAR). The Europe/Middle East/Africa (AuAFMe) segment has been largely flat. Growth in the companion Animal segment appears stable in major regions throughout 2010 to 2012, and a weakening of the livestock segment is likely the culprit of Zoetis' slowing growth in 2012.

FIGURE 8

Contribution of recent acquisitions to overall Zoetis growth ($ millions)



Source: Company Reports; Barclays Research. FDAH – Fort Dodge; KAH – King Animal Health.

FIGURE 9

Zoetis annual base revenue growth by region and species

	2010A	2011A	2012A*
US	13%	7%	6%
Livestock	10%	5%	2%
Companion animals	3%	2%	4%
EuAfMe	-1%	3%	0%
Livestock	-1%	1%	0%
Companion animals	0%	2%	0%
APAC	15%	12%	8%
Livestock	14%	7%	4%
Companion animals	1%	5%	4%
CLAR	5%	9%	4%
Livestock	2%	6%	1%
Companion animals	3%	3%	3%
Total	7%	7%	5%

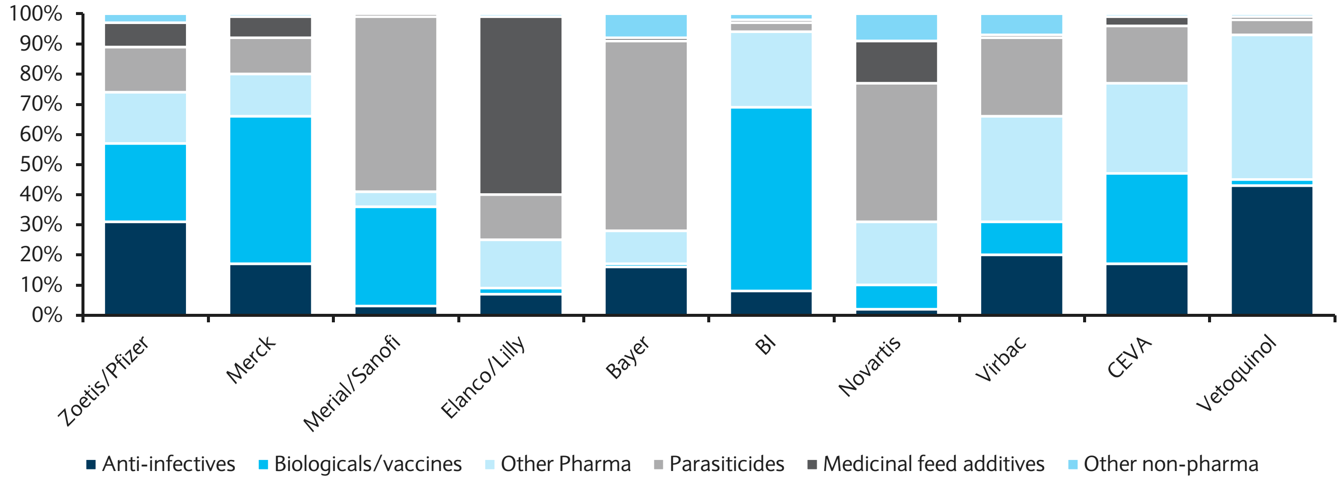
Source: Company Reports; Barclays Research. *2012 growth rates include the first nine months of performance.

Highly diversified: Among 300 product lines, only 23 had sales exceeding 1% of total revenue

Well-balanced portfolio increases immunity to performance volatilities. Zoetis' revenue mix appears highly diversified as compared to animal health and human pharmaceutical peers. The top 10 Zoetis products contributed ~38% of total revenues in 2011. Among 300 product lines, only 16 livestock animal products had 2011 sales that exceeded 1% of total company sales (>$42mn), and only seven companion animal products exceeded the 1% sales barrier. Rimadyl – an anti-inflammatory for companion animals – is among Zoetis' oldest and best-selling products, and its 2011 sales were just under $100mn by our estimates. Figure 10 demonstrates Zoetis' 2011 portfolio mix by product type as compared to the top 10 peers. The company appears well balanced in comparison of players such as Merial, Elanco, and Bayer. We believe Zoetis' diversified portfolio provides immunity or at least some cushion to volatilities in performance due to R&D or supply issues associated with specific products. Zoetis' portfolio distribution amongst geographies and species is compared across the overall industry in Figure 11and Figure 12. As expected, Zoetis has a strong U.S. presence, but its European operations fall behind the industry average given the competition of large European players (i.e. Bayer, Novartis, and BI). While sales to the cattle industry contributed nearly 40% of Zoetis' revenue, Zoetis' companion animal franchise (34%) was still below the industry average in 2011.

FIGURE 10

2011 Animal health sales by therapeutic areas as a % of total sales



Source: Vetnosis. BI = Boehringer Ingelheim.

FIGURE 11

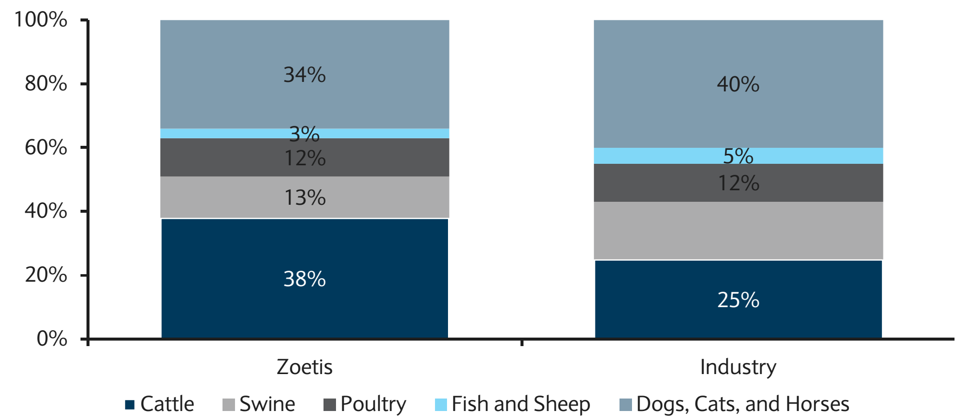
Zoetis recent sales distribution by geographic regions as compared to total industry

	2009A	2010A	2011A	Industry 2011A
US	40.0%	38.6%	39.2%	29.0%
EuAfMe	31.9%	28.5%	27.0%	34.0%
CLAR	16.3%	18.5%	18.6%	17.0%
APAC	11.7%	14.3%	15.2%	20.0%

Source: Company Reports; Barclays Research.

FIGURE 12

Zoetis' revenues in 2011 by species vs. overall industry



Source: Vetnosis Outlook 2012; Barclays Research.

Financial Outlook: Steady workhorse with solid cash flow generation

Upside to revenue growth and EBIT expansion in 2013 likely limited

We project 4.5% revenue growth in 2013, which reflects a modest recovery from the 2% reported growth during the first 9 months of 2012 but still below the long-term trajectory of overall industry growth. Given macro conditions (see our Key Debates discussions), we project limited upside to revenue estimates in 2013. We model a robust improvement of EBIT from ~23% in 2012 to 25% in 2013, and hence, we believe that upside to EPS in 2013 will likely be limited since optimistic leverage potential is already included in our assumptions (please see Key Debate: Zoetis' margin story – More to come or nearing the finish line?). In the longer term, we project a 6% revenue growth coupled with a 13% EBIT growth (2013E-2015E), and potential upside will likely depend on the pace of industry expansion as well as successful portfolio and acquisition integration.

Highly levered for now; expect strong cash flow generation to improve leverage over time

We estimate Zoetis completed 2012 with approximately $0.6bn in cash and cash equivalents, with total debt of ~$3.6bn. Therefore, the company appears highly levered. We highlight the rapid growth in operating cash flow from 2009 to 2012, which can largely be attributed to the benefits of major acquisitions in our view. We project operating cash flow to be ~$650mn by the end of 2013 and expand to $1.2bn by 2015. Given the robust operating cash flow generation, we expect Zoetis' leverage outlook to improve rapidly in the upcoming 3-5 years. Zoetis' capital expenditures have been relatively stable, between

$125mn and $135mn, in the last three years. We expect a notable increase to the $170mn level in 2013 and 2014 given costs incurred in the establishment capabilities that had been previously shared by the Pfizer parent (i.e. finance, HR, etc). In the longer term, we project a return to a steady annual capital expenditure range of $130mn-$150mn. With no debt maturing until 2016 and a relatively low dividend payout in the near term, we have confidence in the company's ability to meet its financial obligations.

FIGURE 13

Historical and projected Zoetis P&L

$USD mn	FY09A	FY10A	FY11A	FY12E	FY13E	FY14E	FY15E	CAGR 13-15
>>>TOTAL REVENUE	2,760	3,582	4,233	4,331	4,527	4,790	5,089	6%
Cost of Goods Sold	1,001	1,318	1,581	1,579	1,607	1,658	1,730	
Gross Profit	1,759	2,264	2,652	2,752	2,920	3,133	3,359	
SG&A	1,057	1,365	1,447	1,415	1,408	1,439	1,502	
R&D	365	411	407	405	395	408	421	
Adjusted Operating Income (EBIT)	322	496	806	978	1,145	1,306	1,447	
EBITDA	426	617	940	1,117	1,291	1,452	1,561	10%
Total Other Income (Expense)	26	37	36	31	111	108	103	
Pre-Tax Income	296	459	770	947	1,034	1,199	1,345	
Income Taxes	108	183	264	326	297	348	390	
GAAP Net Income	(100)	110	245	576	665	779	883	
Adjusted Net Income	189	275	503	619	733	847	951	14%
Diluted Shares Outstanding					525	525	525	
GAAP Diluted EPS	$ -	$ -	$ -	$ -	$ 1.26	$ 1.49	$ 1.68	
>>>ADJUSTED DILUTED EPS	$ -	$ -	$ -	$ -	$ 1.40	$ 1.61	$ 1.80	13%
Dividend	$ -	$ -	$ -	$ -	$ 0.26	$ 0.31	$ 0.37	20%
Gross Margin	63.7%	63.2%	62.7%	63.5%	64.5%	65.4%	66.0%	+ 75 bp
SG&A	38.3%	38.1%	34.2%	32.7%	31.1%	30.0%	29.5%	- 80 bp
R&D	13.2%	11.5%	9.6%	9.3%	8.7%	8.5%	8.3%	- 25 bp
Operating Margin	11.7%	13.8%	19.0%	22.6%	25.3%	27.3%	28.4%	+ 160 bp
EBITDA Margin	15.4%	17.2%	22.2%	25.8%	28.5%	30.3%	30.7%	+ 105 bp
Tax Rate	36.5%	39.9%	34.3%	34.4%	28.7%	29.0%	29.0%	+ 15 bp
Profit Margin	6.8%	7.7%	11.9%	14.3%	16.2%	17.7%	18.7%	+ 125 bp
Revenue Growth Y/Y		30%	18%	2%	5%	6%	6%	
Operating Margin Change Y/Y		+ 220 bp	+ 520 bp	+ 350 bp	+ 270 bp	+ 200 bp	+ 120 bp	
EBITDA Growth Y/Y		45%	52%	19%	16%	12%	7%	
Adjusted Diluted EPS Growth Y/Y						15%	12%	

Source: Company Reports; Barclays Research.

FIGURE 14

Historical and projected Zoetis cashflow and balance sheet summaries

$USD M	FY09A	FY10A	FY11A	FY12E	FY13E	FY14E	FY15E	CAGR 13E-15E
GAAP Net Income	(101)	111	248	576	665	779	883	
Depreciation and Amortization	124	185	205	139	147	146	114	
Non-Cash Items	(282)	(142)	161	(76)	24	24	24	
Other changes in assets & liabilities	357	100	(117)	(42)	(188)	(126)	142	
Cash Flow from Operations	98	254	497	597	647	823	1,163	34%
CapEx	(135)	(124)	(135)	(140)	(170)	(170)	(127)	-13%
Net proceeds from sales of assets	572	203	34	0	0	0	0	
Acquisitions	(2,254)	(81)	(345)	0	0	0	0	
Cash Flow from Investments	(1,821)	(9)	(449)	(153)	(170)	(170)	(127)	
Sale/Repurchase of Equity	0	0	0	0	0	0	0	
Dividends paid	(101)	(207)	(416)	(83)	(137)	(164)	(197)	
Issuance (reduction) of debt	719	0	(143)	0	2,650	0	(400)	
Net financing activities with Pfizer	1,205	(67)	529	123	(2,650)	0	0	
Cash Flow from Financing	1,823	(277)	(30)	40	(137)	(164)	(597)	
Change in Cash and Equivalents	93	(36)	16	484	341	489	439	
>>>FREE CASH FLOW	99	63	79	563	904	1,393	1,832	42%
Cash & Short-Term Investments		63	79	563	904	1,393	1,832	
Accounts Receivable, net		773	871	926	992	1,050	1,004	
Inventories		995	1,063	1,021	1,162	1,235	1,289	
Current Assets		2,116	2,311	2,730	3,289	3,927	4,395	
PP&E, net		1,148	1,243	1,264	1,307	1,349	1,381	
Intangible Assets, net		924	928	908	889	870	852	
Goodwill		934	989	989	989	989	989	
Non-Current Assets		162	240	240	240	240	240	
TOTAL ASSETS		5,284	5,711	6,131	6,713	7,376	7,857	
Accounts Payable		206	214	173	176	145	247	
Total Debt		711	575	575	3,650	3,650	3,650	
TOTAL LIABILITIES		1,940	1,975	2,087	5,182	5,185	5,331	
Shareholders' Equity		3,344	3,736	4,045	1,531	2,191	2,526	
TOTAL LIABILITIES + EQUITY		5,284	5,711	6,131	6,713	7,376	7,857	
>>>NET DEBT		648	496	12	2,746	2,257	1,818	-19%
Net Debt / EBITDA		1.1x	0.5x	0.0x	2.1x	1.6x	1.2x	

Source: Company Reports; Barclays Research.

The valuation conundrum: A first-of-its-kind IPO

Only pure-play, public animal health player with over $1bn in sales

Zoetis is the only public, pure-play animal health company with annual revenue in exceess of $1bn in2012. The six other global players with more than $1bn in sales all exist as parts of global, diversified human pharmaceutical companies. These animal health business units, in our view, are overshadowed by their human counterparts in terms of driving valuations for these companies. The next largest pure-play, public company – Virbac – is significantly smaller, with annual sales of €695mn in 2012. Virbac, therefore, is approximately one-fifth of Zoetis' size by revenues, and meaningful differences exist in business models, end markets, portfolios, and ultimately long-term cash flow generation profiles. Hence, Zoetis' valuation presents somewhat of a conundrum for investors as there are few comparable companies.

AH benefits from positive drivers that no longer exist in human health: high brand loyalty, low generic erosion, solid pricing leverage, and R&D productivity. These features warrant premium valuation over human pharma, in our view

Mid-single-digit base revenue growth solid but not spectacular; robust EBIT expansion is a differentiator. In Figure 15, we present the relative performance and valuation metrics of healthcare companies across the sub-sectors, as well as individual animal health players in diagnostics, drugs, devices and supplies. Zoetis' medium-term revenue CAGR of 4% (FY2011A-14E) stands on par with U.S. Specialty Pharmaceuticals and EU Pharma, and it looks more optimistic than the top-line growth of U.S. major pharmaceuticals, whose medium-term growth trajectory will still likely be weighed down by global patent expiries. Its medium-term EBIT CAGR of 10% (FY13E-15E) looks more attractive than US/EU pharmas as well as the Device and Supplies sector. The current stock price of $33.82 represents a P/E multiple of 24x and an EV/EBITDA of 15x. These multiples are notably higher than our mid- to large-cap healthcare names cited. As compared to the animal health drug companies (Dechra Pharmaceuticals, Vetoquinol, and Virbac), ZTS' valuation multiples are notably higher than the group average of 16.5x P/E and 13x EV/EBITDA. All three drug companies cited have annuals sales under $1bn, and we highlight that given the smaller size and different maturity stage, these companies have revenue growth CAGRs of 5%-11% (mean of 10%) from 2011-2014E, which are higher than that of ZTS. Finally, the current dividend yield of 1% and projected payout ratio for 2013 of 19% looks modest relative to other healthcare players.

Price target of $35 reflects a 25xP/E and a 16x EV/EBITDA. Without the burden of global patent expiries and with a lighter regulatory scrutiny, we believe that Zoetis should warrant higher valuation multiples than both U.S. and EU major pharmaceuticals. The animal health sector retains many positive features that had benefited the therapeutic/pharma space several decades ago: higher R&D productivity and efficiency, pricing leverage, brand loyalty, and greater freedom from regulatory pressures on both R&D and commercial activities. Our DCF model shows an EV/share of $35, based on a 7% discount rate of 5-year cash flow and a terminal growth rate of 2.5% (Figure 17). This analysis drives our PT of $35, which reflects a P/E multiple of ~25x (Figure 16) and an EV/EBITDA of 16x. We believe these premium multiples to human pharma companies are justified given a stability of revenue growth without the risk of generic erosion, lower barriers for R&D success and commercial launch, and stronger pricing leverage. The current stock price, in our view, appears fairly valued. We believe that an increase in payout ratio for this mature animal health company in the medium to long term should help maintain investor interest.

FIGURE 15

Valuation metrics of various health care and related sectors

	Revenues	EBIT	EPS	EBIT margin (%)	P/E (x)	EV/EBITDA (x)	Dividend yield (%)	Dividend Payout Ratio
Sectors	CAGR 11A-14E	CAGR 13E-15E	CAGR 13E-15E	2013E	2013E	2013E	2013E	2013E
Medical Devices & Supplies								
Cardio	2%	6%	10%	23.6	17.2	11.14	1.18	14%
Ortho - Recon	4%	5%	9%	26.9	14.2	8.13	1.16	17%
Medical Products	5%	9%	11%	18.4	16.5	9.87	0.69	10%
US Pharma	0%	6%	9%	33.2	15.9	11.07	2.66	38%
US Specialty Pharma	5%	6%	10%	31.9	11.4	9.26	1.17	7%
EU Pharma	4%	8%	10%	27.7	13.9	11.19	3.45	46%
EU Devices & Supplies	8%	10%	16%	19.9	18.1	9.88	1.83	24%
Food & Nutritionals	7%	8%	11%	17.2	19.4	13.96	2.63	56%
Various Animal Health								
AH - Diagnosis	9%	11%	17%	12.0	32.3	15.52	-	0%
Abaxis	14%	21%	29%	12.4	42.0	22.27	-	0%
Heska Corp	12%	81%	58%	3.0	28.9	8.93	-	0%
IDEXX Laboratories	7%	10%	11%	19.9	26.0	15.37	-	0%
AH - Drugs	10%	11%	12%	6.0	16.5	12.87	1.53	31%
Dechra Pharmaceuticals	11%	14%	27%	6.0	18.4	17.44	1.89	50%
Vetoquinol	5%	8%	8%	NA	12.3	7.67	1.41	17%
Virbac S.A.	11%	10%	12%	NA	18.7	13.48	1.30	25%
AH - Distributor	6%	9%	13%	7.7	17.7	9.79	1.41	19%
MWI Veterinary Supply	18%	13%	12%	4.1	27.1	15.65	-	0%
PetMed Express Inc.	0%	NA	6%	10.9	15.8	8.03	4.70	74%
PetSmart Inc.	7%	10%	15%	9.6	16.1	7.54	0.96	15%
Henry Schein Inc.	6%	8%	11%	7.1	18.5	11.08	-	0%
Patterson Cos. Inc.	4%	5%	11%	10.1	16.5	10.29	1.38	23%
Central Garden & Pet	3%	17%	38%	4.4	12.3	6.19	-	0%

Source: FactSet (data from close of market on March 11, 2013); Barclays Research; Company Reports.

FIGURE 16

Valuation analysis based on P/E multiples and a range of 2013 non-GAAP EPS for ZTS

EPS	PRICE PER SHARE				
Non-GAAP	23.0x	24.0x	25.0x	26.0x	27.0x
$1.30	$29.90	$31.20	$32.50	$33.80	$35.10
$1.35	$31.05	$32.40	$33.75	$35.10	$36.45
$1.40	$32.20	$33.60	$35.00	$36.40	$37.80
$1.45	$33.35	$34.80	$36.25	$37.70	$39.15
$1.50	$34.50	$36.00	$37.50	$39.00	$40.50

Source: Barclays Research; Company Reports.

FIGURE 17

Barclays Research DCF valuation of ZTS

Enterprise Value

Discount Rate	1-yr PV of 2013E-2018E Cash Flows		PV of Terminal Value at a Perpetual Growth Rate of: 2.0%	2.5%	3.0%		WACC	ENTERPRISE VALUE 2.0%	2.5%	3.0%
6.0%	$3,962		$20,281	$23,328	$27,405		6.0%	$24,243	$27,290	$31,367
6.5%	$3,906		$17,587	$19,906	$22,896		6.5%	$21,492	$23,811	$26,802
7.0%	$3,850	+	$15,447	$17,264	$19,540		7.0%	$19,297	$21,114	$23,390
7.5%	$3,796		$13,708	$15,164	$16,948	=	7.5%	$17,504	$18,961	$20,744
8.0%	$3,743		$12,269	$13,459	$14,889		8.0%	$16,012	$17,202	$18,632

Equity Value

	Net Debt (Cash)		EQUITY VALUE 2.0%	2.5%	3.0%		WACC	EQUITY VALUE PER SHARE 2.0%	2.5%	3.0%
	$2,746		$21,496	$24,543	$28,621		6.0%	$40.95	$46.75	$54.52
	$2,746		$18,746	$21,065	$24,055		6.5%	$35.71	$40.12	$45.82
-	$2,746		$16,550	$18,367	$20,644		7.0%	$31.52	$34.99	$39.32
	$2,746	=	$14,758	$16,214	$17,998	=	7.5%	$28.11	$30.88	$34.28
	$2,746		$13,266	$14,456	$15,886		8.0%	$25.27	$27.53	$30.26

Source: Barclays Research; Company Reports.

Key Debate: Global growth – A pause or a new normal?

Sector long-term growth expected at 5.7% CAGR from 2011A-2016E, but 2012 looks to have been below this trajectory. At the end of 2011, the global animal health market stood at ~$22bn in annual sales. Recently, Bayer – whose animal health division produced ~€1,200mn in sales in 2011 – reported the global animal health market grew by 4% in 2012, just shy of the projected long-term growth trend. Similar to human pharmaceuticals and other segments, it appears that the animal health market is experiencing some softening in growth.

FIGURE 18

Bayer projected global sector growth rates over 2011 and 2012

	WW Growth YOY (%)	
	2011	**2012**
Human Pharmaceuticals	6%	3%
Consumer Care	5%	4%
Medical Care	2%	1%
Animal Health	5%	4%

Source: Bayer Annual Report 2012; Barclays Research.

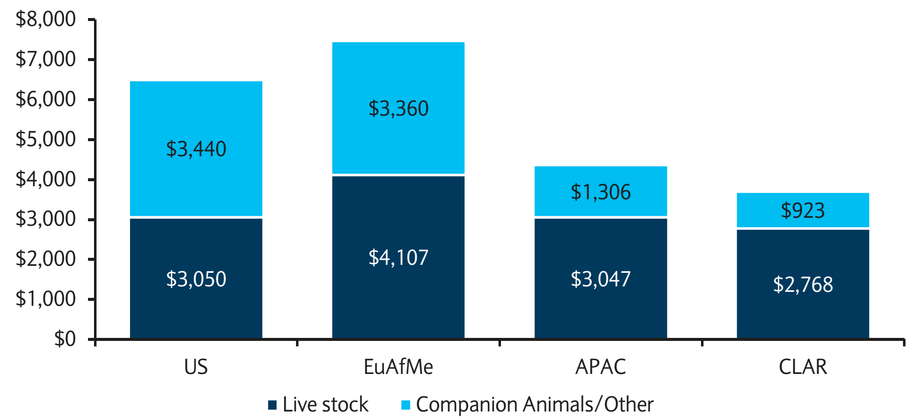
No bull market for the livestock market?

Two-thirds of Zoetis' sales come from the livestock market; higher dependence than peers

Livestock drives over half of overall AH market sales and two-thirds of Zoetis' revenues. The livestock industry constituted ~$13bn or 59% of the $22bn global animal health industry by the end of 2011. Vetnosis projects 5% livestock animal segment growth from 2011 to 2016. Approximately two-thirds of Zoetis' 2012 revenues came from sales into the livestock segment (Figure 20). With this higher-than-market representation of sales, volatilities in the livestock industry's demand for AH products are likely a strong determinant for Zoetis' revenue outlook. In Figure 19, we present the division between livestock and companion animal sales among major geographies at the end of 2011. The U.S. is the only market in which livestock animals constitute less than half of the total revenues (47%), and in each of the other geographic markets, livestock still makes up the majority of animal health product sales (EuAfMe – 55%; APAC – 70%, and CLAR – 75%).

FIGURE 19

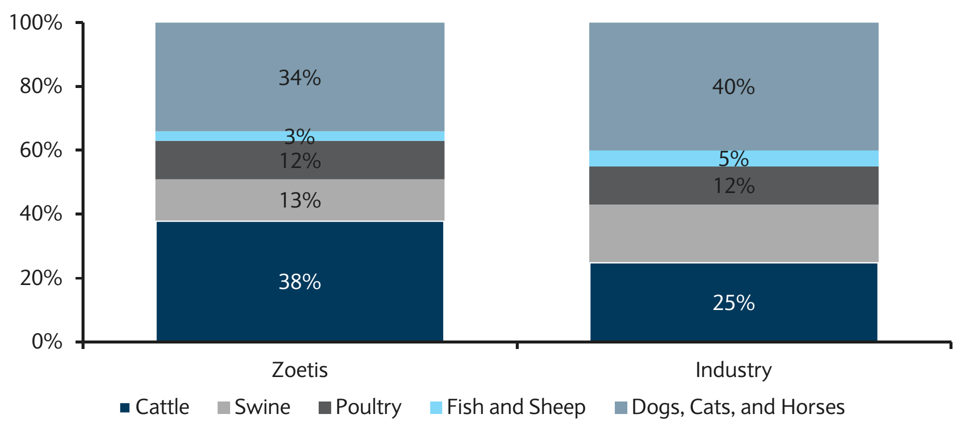
Vetnosis estimated 2011 global animal health industry revenues by species and regions



Source: Vetnosis STORM Forecast (July, 2012); Barclays Research. All values in millions of USD.

FIGURE 20

Zoetis' revenues in 2011 by species vs. overall industry



Source: Vetnosis Outlook 2012; Barclays Research.

Cattle is the single biggest driver of Zoetis sales; trends in the cattle market should have meaningful implications for Zoetis' growth projections

Cattle account for nearly 40% of Zoetis' sales. During the first 9 months of 2012, Zoetis reported a U.S. base revenue growth of 6%, which was supplemented by 1% from acquisitions, for a total of 7% reported growth (excluding currency effects). We highlight that the U.S. business base growth rate declined from 13% in 2010, to 7% in 2011, and 6% in 2012 (Figure 21). Downward pressures on the livestock industry – more specifically, cattle production – likely had some impact. Cattle is the single largest species segment for Zoetis, representing 38% of Zoetis' 2011 sales vs. the industry average of 25% (Figure 20), and we believe trends in livestock and cattle production will be a key indicator for Zoetis' global performance in the future.

FIGURE 21

Zoetis base growth (exclusive of FX and acquisitions) – YOY%.

	2010A	2011A	2012E*
US	13%	7%	6%
Livestock	10%	5%	2%
Companion animals	3%	2%	4%
EuAfMe	-1%	3%	0%
Livestock	-1%	1%	0%
Companion animals	0%	2%	0%
APAC	15%	12%	8%
Livestock	14%	7%	4%
Companion animals	1%	5%	4%
CLAR	5%	9%	4%
Livestock	2%	6%	1%
Companion animals	3%	3%	3%
Total	7%	7%	5%

Source: Company Reports; Barclays Research. * First 9 months of 2012 have been reported by Zoetis

Zoetis' global cattle revenues down -2% during the first 9months of 2012, likely driving overall livestock flat performance; 2013 will likely be another lean year

No growth in livestock for Zoetis in 2012; softness in global cattle market likely the culprit. The U.S. cattle industry saw six consecutive years of herd size decline through 2012 given multiple headwinds: rising feed prices, limited water reserves due to drought, as well as uncertainties with consumer demand given rising prices. Trends are similar in Europe, where the USDA projects a 1% decline in herd size in 2013. We believe that the 2% YOY decline in the cattle revenue sales during the first 9 months of 2012 is likely due to overall volume contractions in the U.S. cattle industry as well as in other developed markets. Softness in cattle likely drove the slowing of growth in Zoetis' overall livestock sales in 2012 (0% YOY). The USDA projects that 2013 will likely be another year of herd size declines (-1% YOY for cattle in the U.S. and EU; +1% in APAC and CLAR). Given Zoetis' dependence on the livestock sector, particularly cattle, we model higher-than-peer pressures from the U.S. livestock industry stagnation. We model 2013 base growth of 4% for Zoetis in the U.S., which we expect to rebound to 6% in 2014.

FIGURE 22

YOY growth rates of Zoetis revenues by species

	YOY Growth (%)		
	2010A	2011A	2012A*
Livestock	32%	24%	0%
Cattle	30%	10%	-2%
Swine	12%	30%	3%
Poultry	112%	89%	-1%
Other (Fish and Sheep)	51%	38%	14%
Companion Animal	26%	8%	5%
Horses	99%	6%	6%
Dogs and Cats	20%	8%	5%

Source: Company Reports; Barclays Research. * First 9-months of 2012 have been reported by Zoetis.

FIGURE 23

Historical and projected cattle herd size by geographic region (in 1,000s of heads of animals)

	2008A	2009A	2010A	2011A	2012A	2013E	CAGR 2008-13E
US	96,035	94,521	93,881	92,682	90,769	89,700	-1%
EuAfMe	150,431	149,536	148,356	146,353	144,953	143,831	-1%
APAC	460,725	465,497	472,648	476,084	479,675	484,403	1%
CLAR	304,441	306,927	306,761	310,300	317,696	324,986	1%
Global	1,011,632	1,016,481	1,021,646	1,025,419	1,033,093	1,042,920	1%

Source: USDA – PSD database.

Drought and high feed prices compress U.S. production inventory. Over the past two years, the U.S. livestock industry has been coping with a significant lack of rainfall, and the key affected geographic regions include central and southwestern states (i.e. Texas, Oklahoma, New Mexico, Kansas, and Louisiana, etc; Source: Global Drought Monitor 2013). Key international markets have not been immune to droughts, and there have been reports of low rainfalls impacting production in Brazil, Mexico/Central America, and Southern Europe. The Economic Research Service (ERS) of the USDA published a cautious U.S. livestock outlook on Jan 17, 2013, in which the agency stated that "as the drought continues, potential for more cow liquidation increases and prospects for herd rebuilding deteriorate." The agency also highlighted other factors that affect the cattle/beef market, including record-high beef prices and concerns about the consumer's disposable income level. The same report highlights a stable to slightly higher inventory of swine and poultry production in the U.S. On Feb 22, 2013, the World Agriculture Outlook Board of the USDA estimated that in 2012, U.S. livestock and poultry production grew 1%, where declines in beef and boiler production were more than offset by an increase pork and turkey production. With a combination of loss of pasture and pond water reserves and a spike in feed prices as corn crop deteriorated in mid 2012, the USDA projected that cow herd liquidation was ~3.3mn heads in 2012, which is slightly down from 2011 but still relatively high as a proportion of total inventory.

U.S. cattle herd declined for a 6th consecutive year in 2012; seeing modest growth in swine and poultry. We present both historical and projected cattle and swine inventory from the U.S. and key international markets in Figure 23,

Figure 24, and Figure 25. From 2008 to 2013, the USDA projects herd sizes for both U.S. cattle and swine production to decline by 1%, driven largely by a combination of drought, rising feed prices, and softer consumer demand given the macroeconomic environment. We are observing a similar -1% CAGR for European production of cattle and swine over the 2008-2013E period. There has been modest growth of cattle and swine in APAC and CLAR, however (1% CAGR over 2008A-2013E).

2013 outlook: New Year, but the same drought. The outlook for 2013, according to the USDA report, remains highly dependent on both feed prices and rainfall levels in 1H 2013. The USDA expects some relief in feed prices in 1H13 as 2013 corn and soybean crops are harvested. Rainfall remains an uncertainty for major production areas in the U.S. The USDA expects cattle and swine to continue to contract during 2013 (-1% YOY in 2013), and sheep and lamb to fall by -3% in 2013 in terms of weight. The agency predicts 0.7% growth in boiler meat production in 2013 and 1% growth in Turkey.

FIGURE 24

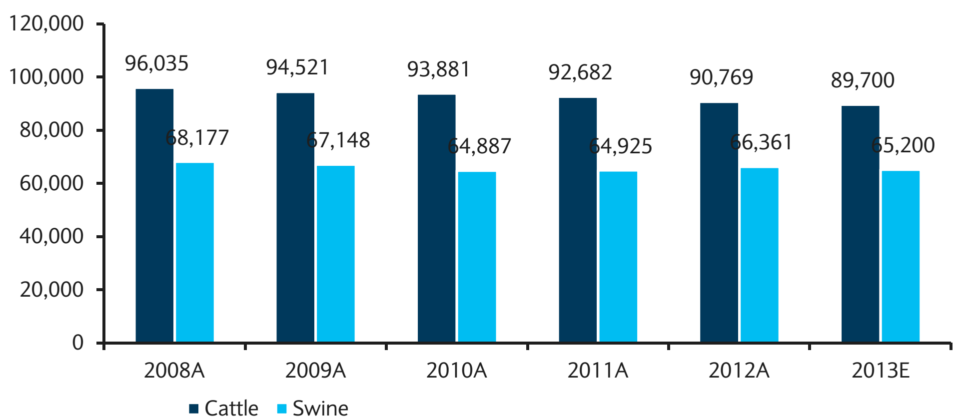
US inventory of livestock – historical and projected (in 1,000s of animals)

US Production	2008A	2009A	2010A	2011A	2012A	2013E	CAGR (2008A-13E)
Cattle	96,035	94,521	93,881	92,682	90,769	89,700	-1%
Swine	68,177	67,148	64,887	64,925	66,361	65,200	-1%

Source: USDA – PSD database.

FIGURE 25

US inventory of livestock – historical and projected (in 1,000s of animals)



Source: USDA – PSD database.

FIGURE 26

International regional swine numbers – beginning stocks in 1000s heads

	2008A	2009A	2010A	2011A	2012A	2013E	CAGR 2008-13E
US	68,177	67,148	64,887	64,925	66,361	65,200	-1%
EuAfMe	186,690	179,462	180,793	179,851	177,165	177,250	-1%
APAC	503,049	525,509	533,045	539,683	535,651	530,407	1%
CLAR	49,425	46,592	47,587	49,342	51,121	52,089	1%
Global	807,341	818,711	826,312	833,801	830,298	824,946	0%

Source: Source: Foreign Agriculture Service, Official USDA estimates, Barclays Research.

Is pet spending recession proof?

Part of the family, but still feeling the squeeze

More Americans then ever consider their companion animals as "part of the family," and the AVMA found that 63% of all U.S. pet owners would concur. At the onset of the recession in 2008, spending on pets appeared to be highly resistant to the uncertain economy, likely due to the attachment between pet owners and their pets. However, based on the most recent survey conducted by the AVMA, American pet owners are cutting back ownership (Figure 27): we observed a 2.4% decline between 2006 and 2011 in the number of U.S. households with pets. While total spending on pets reached the all time high of nearly $53bn in 2012, we are observing some slowing across major expenditure categories in 2012. The AVMA has observed a decrease in visits to veterinarians for some species categories, and veterinary spending was close to flat in 2012 (+1.3% YOY). We believe that in an economically-constrained environment, some pet owners may view OTC medication as an alternative to veterinary care, and this is reflected in the 6.7% YOY growth in OTC medication spending in 2012 (Figure 28).

FIGURE 27

US household pet owndership: Trends between 2006 to 2011

	2006	2011	% Change
All pets	57.4%	56.0%	-2.4%
Dogs	37.2%	36.5%	-1.9%
Cats	32.4%	30.4%	-6.2%
Birds	3.9%	3.1%	-20.5%
Horses	1.8%	1.5%	-16.7%
Specialty/Exotics	12.7%	10.6%	-16.5%

Source: AVMA; Barclays Research.

FIGURE 28

Companion animal spending by category: 2010-2012

	Expenditures ($Bn)			YOY Growth (%)		CAGR
	2010 Actual	2011 Actual	2012 Actual	2010-2011	2011-2012	2010-2012
Food	18.76	19.85	20.46	5.8%	3.1%	4.4%
Supplies/OTC Med	10.94	11.77	12.56	7.6%	6.7%	7.1%
Veterinary Care	13.01	13.41	13.59	3.1%	1.3%	2.2%
Live Animal Purchases	2.13	2.14	2.15	0.5%	0.5%	0.5%
Other services	3.51	3.79	4.11	8.0%	8.4%	8.2%
Total	48.35	50.96	52.87	5.4%	3.7%	4.6%

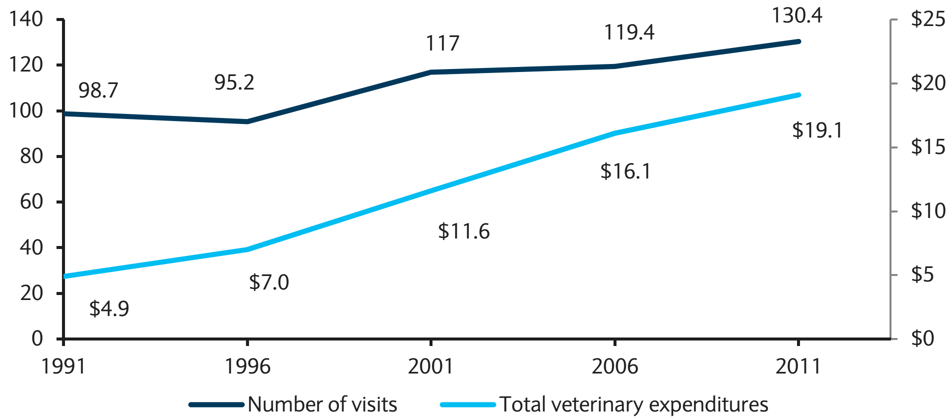
Source: APPA; Barclays Research.

Seeing another flat year for veterinary spending in 2013

Veterinary spending expected to see flatter growth; a decline in total visits offset by higher spending at each visit. Total number of veterinary visits continues to grow for households with dogs since the onset of the recession, albeit at a slower rate than previously (2% CAGR 2006-11). Strikingly, we observed a decline in visits for cat-owning households (-1% CAGR 2006-2011). Spending on veterinary expenditures, however, continue to grow at a 3% CAGR for dog-owning households and 1% for cat-owing households (Figure 29, Figure 30). The AVMA believes the decrease in visits suggest a possible decline in preventive care, which predominately include vaccinations. The Bayer Veterinary Care Usage Study (2011) suggests that key factors driving the decline include the economic recession, fragmentation of veterinary services, availability of alternative information sources (i.e. internet), as well as the "sticker shock" of rising costs per visits. The overall uncertainty on disposable spending, in our view, is the most important driver, and we expect another year of flat or nearly flat growth in total veterinary spending in 2013.

FIGURE 29

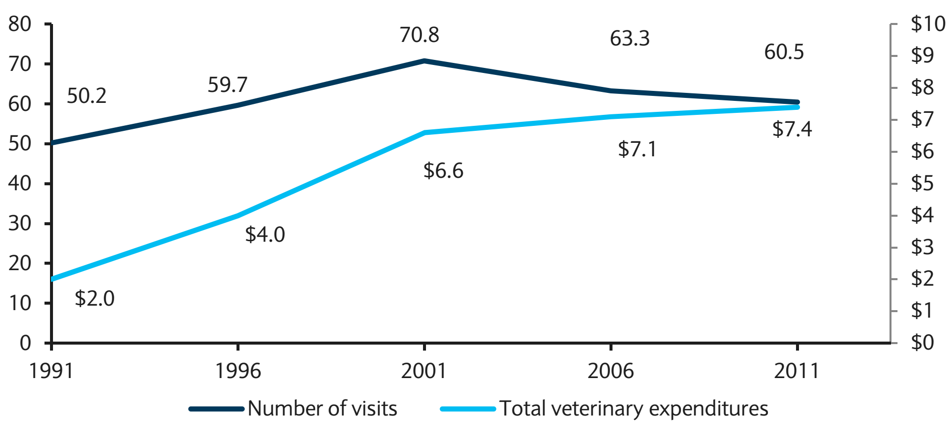
Total number of veterianary visits for dog-owning house holds and total veteinary expenitures



Source: AVMA Source Book 2012; Number of visits in millions; total veterinary expenditures in billions of USD.

FIGURE 30

Total number of veterianary visits for cat-owning house holds and total veteinary expenitures



Source: AVMA Source Book 2012; Number of visits in millions; total veterinary expenditures in billions of USD.

FIGURE 31

2011 vetenariy services as classified by companion animal species – US analysis

	All companion animals	Dog	Cat	Bird	Horse	Specialty
Mean per household ($)	375	378	191	33	373	37
Mean per visit ($)	138	146	122	97	197	101
Mean per pet ($)	134	227	90	14	133	5
Total expenditures (in billions of USD)	28.002	19.080	7.365	0.145	0.826	0.586
% of total expenditures		68%	26%	1%	3%	2%

Source: US Pet Ownership Demographics Source Book; 2012 Edition; Barclays Research.

FIGURE 32

2011 number of vetenariy visits as classified by companion animal species – U.S. analysis

	All companion animals	Dog	Cat	Bird	Horse	Specialty
Mean per household	2.7	2.6	1.6	0.3	1.9	0.4
Mean per pet	1.0	1.6	0.7	0.1	0.7	0.14
Total number of visits (in millions)	202.4	130.4	60.5	1.5	4.2	5.8

Source: US Pet Ownership Demographics Source Book; 2012 Edition; Barclays Research.

The emerging market is the bright spot. Pet spending in the U.S. appears to be reaching a mature stage with low-single-digit growth (~3% CAGR 2007-2012), likely compounded by economic uncertainties. We believe similar trends would be found in the developed European markets. The emerging markets appear to provide some boost to the growth pattern. In Figure 33, we present a comparison of pet ownership and expenditure growth rates between the U.S. and Latin America. Increased disposable income and availability of veterinary care and products are driving double-digit growth in Latin American pet spending.

FIGURE 33

Companion animal ownership and spending patterns in the US and Latin America (2006-2012)

Total Spending on Pets ($Bn)	2007	2012	CAGR (2007-2012)
US	24	28	3.1%
Latin America	6	12	14.9%
Total dog and cat populations (millions)	**2007**	**2012**	**CAGR (2007-2012)**
US	160	160	0.0%
Latin America	95	112	3.3%
Average spending per pet ($)	**2007**	**2012**	**CAGR (2007-2012)**
US	148	174	3.3%
Latin America	68	110	10.1%

Source: Euromonitor release June 2012; Barclays Research; Company Reports.

Implications for Zoetis – developed market pet spending saturation is an overhang; expect emerging markets to offset the softness

Zoetis companion animal business still under-represented; 5% 2012 growth looks more inline with long-term market expansion as compared to livestock. During the first 9 months of 2012, sales for companion animal products accounted for ~36% of Pfizer's total revenue, up from 34% in 2011. Nevertheless, Zoetis' companion animal sales remain lower than the total industry (40%), but we are seeing better growth (5% YOY in the first 9 month of 2012) in this segment as compared to livestock (flat YOY). This CAGR is on pace with Vetnosis' projected growth rate of 5% between 2011 and 2016. Compared to Pfizer's livestock operations, we are seeing more robust growth trends in companion animals. Drivers for growth and hence the growth rates in each geographic region differ (Figure 34). In the U.S., Pfizer's Revolution product line (parasiticide for dog and cats) benefited from a void created by competitor supply disruptions (i.e. Novartis' Interceptor, Setinel, etc). This was coupled with good growth in canine vaccines (Vanguard) and anti-infectives. In the EuAfMe, adverse macroeconomic conditions continue to strain spending, overshadowing positive drivers such as brand generic launches and horse vaccine growth. CLAR growth in

2012 benefited from a longer flea and tick season, and the expansion of canine vaccines drove growth in Brazil. Finally, in APAC, Revolution growth was strong in Australia, and the key driver of growth in China was the canine vaccine portfolio.

Projecting 6% companion animal growth in 2013. For 2013, we model 6% YOY growth in Zoetis' companion animal segment growth. The expansion of preventative care in the emerging markets (i.e. canine vaccines), steady U.S. parasiticides growth, and the launch of branded generics in Europe should help drive growth; this will likely be partially offset by flat overall spending trends in the developed market for veterinary expenditures.

FIGURE 34

Zoetis base growth (exclusive of FX and acquisitions) – YOY%

	2010A	2011A	2012E*
US	13%	7%	6%
Livestock	10%	5%	2%
Companion animals	3%	2%	4%
EuAfMe	-1%	3%	0%
Livestock	-1%	1%	0%
Companion animals	0%	2%	0%
APAC	15%	12%	8%
Livestock	14%	7%	4%
Companion animals	1%	5%	4%
CLAR	5%	9%	4%
Livestock	2%	6%	1%
Companion animals	3%	3%	3%
Total	7%	7%	5%

Source: Company Reports; Barclays Research. * First 9 months of 2012 have been reported by Zoetis.

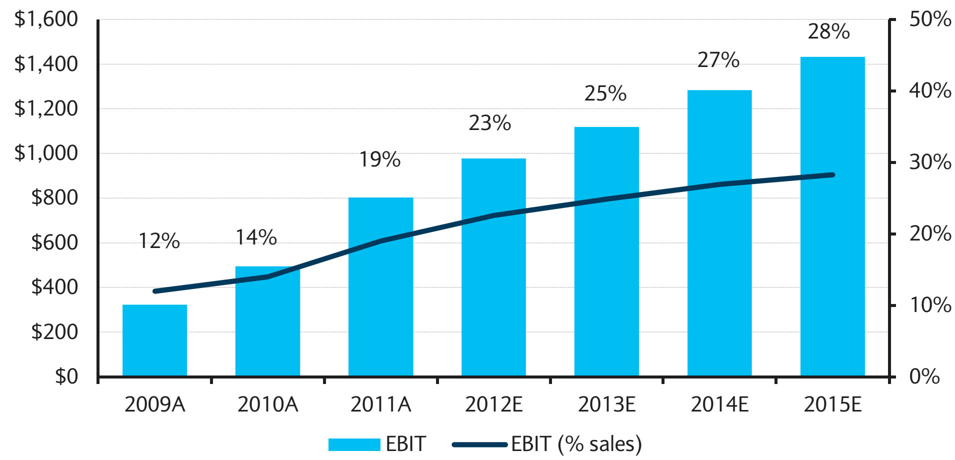
Key Debate: Zoetis' margin story – More to come or nearing the finish line?

King and FDAH have been providing significant scale for margin improvement

Striking margin expansion since 2009; can the momentum continue? A striking feature in the Zoetis story is its adjusted EBIT growth over recent years (Figure 35). Since 2009, Zoetis' adjusted EBIT margin has expanded from 12% to an estimated 23% in 2012. Recent acquisitions – King Pharmaceuticals and FDAH – helped expand sales scale significantly: $718mn in 2010 or 20% of total sales and $995mn in 2011 or 24% of sales). Gains in revenues have provided the scale over the fixed cost base. We have seen a decline of operating expenses as a percent of sales as the top line expands – 52% in 2009, 49% in 2010, and 44% in 2011. Sales synergies to support the acquired portfolios, in our view, have been the key to operating expense efficiency. Gross margin, by comparison, has remained relatively stable, between 63% and 64% over the past few years.

FIGURE 35

Hisotrical and projected adjusted EBIT ($mn)



Source: Company Reports; Barclays Research estimates.

2011 EBIT of 19% still at the low end of peers; headroom exists across expense lines

Compared to the top 10 players, Zoetis' 2011 adjusted EBIT margin of 19% was at the lower end of operating performance. Merck Animal Health (23% EBIT margin), Merial (31%), and BI Animal Health (30%) all came in above Zoetis' margins. LLY/Elanco's 2011 EBIT margin of 18% was below that of Zoetis, likely due to the integration of Janssen Animal Health and other acquisitions. There remains significant room for growth across the expense lines (COGS, SG&A, and R&D) as compared to industry best practices, in our view.

With 13 anchor sites, 16 satellite sites, and 200 CMOs, manufacturing efficiency is likely still a work in progress

Expect a 28% EBIT margin by 2015; manufacturing efficiency and sales structure optimization should be the key drivers. We expect a steady improvement in Zoetis' EBIT margin in the next three years as room for greater leverage exists across COGS, SG&A, and R&D. We project that by 2015, the company could reach an EBIT margin of 28%. In terms of production, Zoetis has 29 manufacturing facilities, of which 13 sites are "anchors" and 16 are "satellites." Improvements in facility efficiency, product mix, and the optimisation of in-house production as well as CMO production (currently a CMO network of 200 facilities) should help drive gross margins towards the higher end of the group spectrum (65% to 69%). We model a 66% gross margin by 2015 (as compared to 63% in 2011). We expect S&A spend to decline from 34% in 2011 to 29% by 2015, and the efficiencies are likely the result of greater synergy progress after the recent acquisitions and optimization of direct vs. third-party sales in the international market. Finally, for R&D, Zoetis currently has ~1,000 R&D staff, and operations are co-located with major international manufacturing sites with the R&D headquarters located in Kalamazoo, Michigan. We expect greater efficiency in the

R&D organization leading to a reduction of R&D expense as a % of sales from 10% in 2011 to ~8% in 2015. Since the absolutely dollar for R&D spend remains low ($405mn in 2012) relative to S&A spend ($1,415mn), we believe the more meaningful leverage will still come from S&A.

FIGURE 36

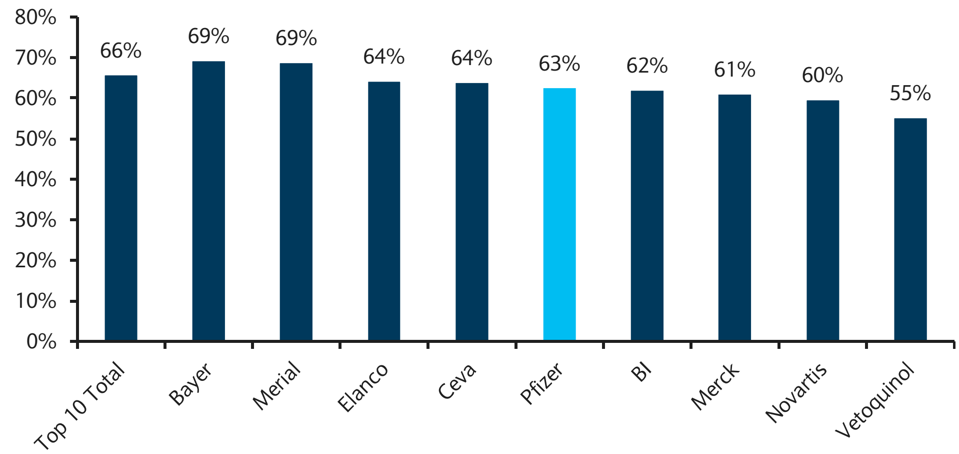
2011 adjusted P&L margins for Top 10 Animal Health players

	COGS (% of sales)	Gross Margins (% of sales)	SG&A (% of sales)	R&D (% of sales)	Operating Expenses (% of Sales)	Operating Profit (% of sales)	EBIT (% of sales)
Top 10 Total	34%	66%	31%	8%	40%	26%	22%
Pfizer	37%	63%	34%	10%	44%	19%	18%
Merck	39%	61%	30%	8%	38%	23%	20%
Sanofi/Merial	31%	69%	31%	7%	38%	31%	23%
LLY/Elanco	36%	64%	36%	10%	46%	18%	16%
Novartis	40%	60%	33%	10%	42%	17%	15%
Bayer	31%	69%	36%	9%	45%	24%	22%
Boehringer Ingelheim	38%	62%	22%	10%	32%	30%	27%
Ceva	36%	64%	38%	9%	47%	17%	15%
Vetoquinol	45%	55%	31%	7%	38%	17%	12%

Source: Vetnosis; Barclays Research.

FIGURE 37

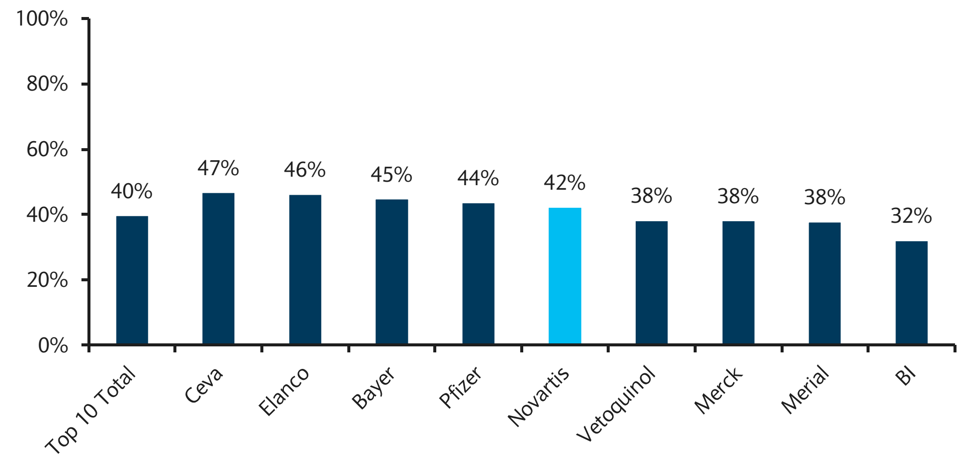
2011 gross margins as a % of sales of top 10 animal health companies



Source: Vetnosis; Barclays Research.

FIGURE 38

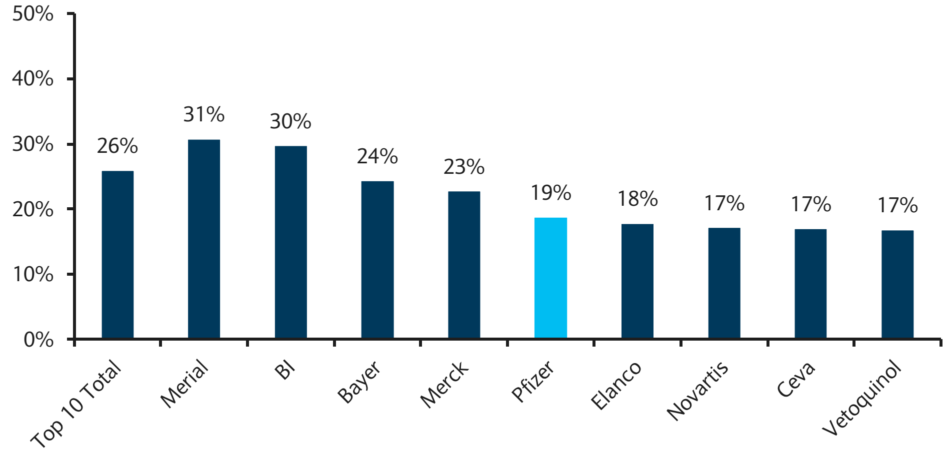
2011 operating expenses as a % of sales of top 10 animal health companies



Source: Vetnosis; Barclays Research.

FIGURE 39

2011 operating profit as a % of sales of top 10 animal health companies



Source: Vetnosis; Barclays Research.

Management Team Profiles

Juan Ramon Alaix, CEO - Mr. Alaix was appointed the CEO of Zoetis in July 2012, and he is also a member of the Board of Directors. He has been serving as the president of PFE Animal Health since 2006. He joined Pfizer from Pharmacia in 2003 as regional president of Central/Southern Europe. He has 35 years of experience in finance, sales, and management, including over 20 years of experience in the pharmaceutical industry. In 2011, he was elected a two-year term as the president of the International Federation for Animal Health (IFAH) in addition to serving as a member of the board and executive committee.

Richard A. Passov, CFO- Mr. Passov was appointed the EVP and CFO of Zoetis in July 2012. He previously served as SVP and treasurer of PFE up to 2001, as well as assistant treasurer in Treasury Planning from 1997. Prior to joining PFE, Mr. Passov was assistant treasurer and director of B&D at Intel. He began his career in planning and finance at Sun Microsystems.

Catherine A. Knupp, President of R&D- Ms. Knupp is the EVP and President of R&D at Zoetis. She has held the position of VP, Veterinary medicine R&D at PFE since 2005. Prior to joining Pfizer Animal Health, she led PFE's Michigan Laboratories and chaired the Midwest Exploratory Development Management Team in Pfizer Global R&D. She began her career in 1987 at Bristol-Myers Squibb, where she held positions in drug metabolism and pharmacokinetics.

FIGURE 40

Zoetis (ZTS) Model – Detailed

$mn	FY09A	FY10A	FY11A	FY12E	13Q1E Mar	13Q2E Jun	13Q3E Sep	13Q4E Dec	FY13E	FY14E	FY15E	CAGR 13-15
>>>TOTAL REVENUE	2,760	3,582	4,233	4,331	1,081	1,135	1,070	1,241	4,527	4,790	5,089	6%
Cost of Goods Sold	1,001	1,318	1,581	1,579	389	409	375	434	1,607	1,658	1,730	
Gross Profit	1,759	2,264	2,652	2,752	692	727	696	806	2,920	3,133	3,359	
SG&A	1,057	1,365	1,447	1,415	332	349	321	407	1,408	1,439	1,502	
R&D	365	411	407	405	86	91	96	122	395	408	421	
Adjusted Operating Income (EBIT)	322	496	806	978	280	294	285	285	1,145	1,306	1,447	
EBITDA	426	617	940	1,117	317	331	322	322	1,291	1,452	1,561	10%
Total Other Income (Expense)	26	37	36	31	28	28	28	28	111	108	103	
Pre-Tax Income	296	459	770	947	253	266	258	257	1,034	1,199	1,345	
Income Taxes	108	183	264	326	72	76	75	75	297	348	390	
GAAP Net Income	(100)	110	245	576	163	173	165	165	665	779	883	
Adjusted Net Income	189	275	503	619	180	190	182	182	733	847	951	14%
Diluted Shares Outstanding					525	525	525	525	525	525	525	
GAAP Diluted EPS	$ -	$ -	$ -	$ -	$ 0.31	$ 0.33	$ 0.31	$ 0.31	$ 1.26	$ 1.49	$ 1.68	
>>>ADJUSTED DILUTED EPS	$ -	$ -	$ -	$ -	$ 0.34	$ 0.36	$ 0.35	$ 0.35	$ 1.40	$ 1.61	$ 1.80	13%
Dividend	$ -	$ -	$ -	$ -	$ 0.07	$ 0.07	$ 0.07	$ 0.07	$ 0.26	$ 0.31	$ 0.37	20%
Gross Margin	63.7%	63.2%	62.7%	63.5%	64.0%	64.0%	65.0%	65.0%	64.5%	65.4%	66.0%	+ 75 bp
SG&A	38.3%	38.1%	34.2%	32.7%	30.7%	30.7%	30.0%	32.8%	31.1%	30.0%	29.5%	- 80 bp
R&D	13.2%	11.5%	9.6%	9.3%	8.0%	8.0%	9.0%	9.8%	8.7%	8.5%	8.3%	- 25 bp
Operating Margin	11.7%	13.8%	19.0%	22.6%	25.9%	25.9%	26.7%	23.0%	25.3%	27.3%	28.4%	+ 160 bp
EBITDA Margin	15.4%	17.2%	22.2%	25.8%	29.3%	29.1%	30.1%	25.9%	28.5%	30.3%	30.7%	+ 105 bp
Tax Rate	36.5%	39.9%	34.3%	34.4%	6.7%	6.7%	7.0%	6.0%	28.7%	29.0%	29.0%	+ 15 bp
Profit Margin	6.8%	7.7%	11.9%	14.3%	16.6%	16.7%	17.0%	14.6%	16.2%	17.7%	18.7%	+ 125 bp
Revenue Growth Y/Y		30%	18%	2%	3%	4%	5%	6%	5%	6%	6%	
Operating Margin Change Y/Y		+ 220 bp	+ 520 bp	+ 350 bp	+ 330 bp	+ 70 bp	+ 220 bp	+ 450 bp	+ 270 bp	+ 200 bp	+ 120 bp	
EBITDA Growth Y/Y		45%	52%	19%	22%	5%	10%	30%	16%	12%	7%	
Adjusted Diluted EPS Growth Y/Y										15%	12%	

Source: Barclays Research; Company Reports.

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Primary Stocks (Ticker, Date, Price)

Zoetis Inc. (ZTS, 12-Mar-2013, USD 33.82), Equal Weight/Positive

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Bristol-Myers Squibb (BMY)	Gilead Sciences (GILD)	Johnson & Johnson (JNJ)
Lilly, Eli (LLY)	Merck & Co. (MRK)	Pfizer Inc. (PFE)
Zoetis Inc. (ZTS)		

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A high/low Quality score indicates financial statement strength/weakness. Measures of quality include ROIC and corporate default probability.

A high/low Sentiment score indicates bullish/bearish market sentiment. Measures of sentiment include price momentum and earnings revisions.

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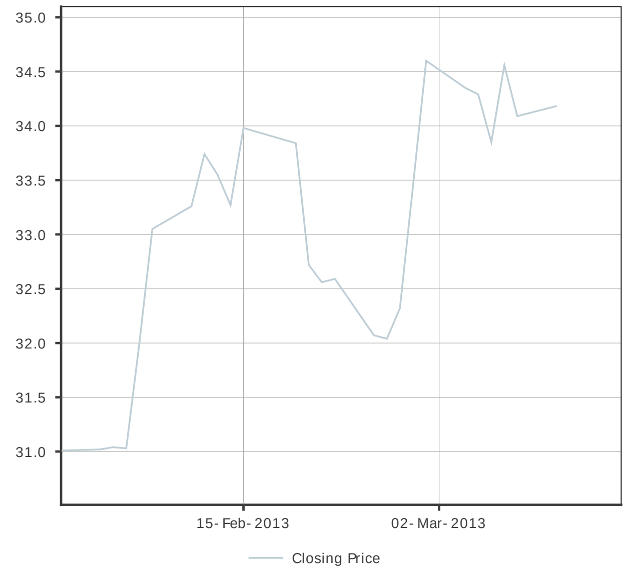
Zoetis Inc. (ZTS)	Stock Rating	Industry View
USD 33.82 (12-Mar-2013)	**EQUAL WEIGHT**	**POSITIVE**

Rating and Price Target Chart - USD (as of 12-Mar-2013)



Currency=USD

Date	Closing Price	Rating *	Price Target

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Valuation Methodology: Our price target of $35 is based on a DCF analysis using a 7% discount rate and a 2.5% terminal growth rate. Our price target is ~25x our FY2013 earnings estimate of $1.40.

Risks which May Impede the Achievement of the Barclays Research Price Target: Risk factors that can materially affect Zoetis' operations and performance include global economic conditions that may affect the consumer's demand for animal proteins and spending on companion animals, potential increase in regulatory scrutiny over the use of antimicrobials in food-producing animals, regulatory and/or funding pressures on livestock production in major markets, changes in consumer demand for animal proteins products due to perceptions of health risks, competition from generic animal health products, outbreak of infectious diseases in animals, and consolidation of customers, particularly in food-producing animal producers, and effects on Zoetis' pricing leverage. Other risks include challenges in integrating recent acquired businesses, setbacks in the R&D pipelines such as failure of clinical trials and denial of drug approvals, manufacturing and capacity shortfalls, as well as challenges to Zoetis' portfolio's patent exclusivity in major markets.

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