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Thomas Chiu

August 7, 2013

Zoetis Inc.

Business on track; ex-US margin potential

Stock Rating
Equal-weight

Industry View
In-Line

Mgmt. reiterated 2013E rev. and EPS guidance midpts of \$4.48B and \$1.39, respectively, and we are leaving our projs unchanged. See below for conf. call highlights and what to watch. Maintain EW.

We left our rev and EPS ests mostly unchanged. We maintained our rev ests. of \$4.47B in '13E, \$4.81B in '14E, and \$5.08B in '15E. We left 2013E EPS unchanged at \$1.41, but tweaked 2014E from \$1.66 to \$1.67 and 2015E from \$1.90 to \$1.91. Our 2H:13E rev. and EPS are unchanged. Our 3Q EPS of \$0.35 is 1 cent above cons'. We model 340 b.p. of operating margin expansion in 2013E from 21.2% to 24.6%. We project 200 b.p. of operating margin expansion annually in 2014E and 2015E; our 2015E O.M. is 28.6%.

Segment disclosure underscores opportunity for margin improvement ex-U.S. U.S. pre-tax margin was 58% in 2Q:13 vs. EuAfME, CLAR, and APAC margins of 33%, 37%, and 38%, respectively. We expect ex-U.S. margins to grow over time as mgmt. realizes operating leverage on the back of mid-to-high single digit rev. growth in CLAR and APAC. See segment profitability tables on pp. 8–9.

Earnings call highlights. Apoquel (first-in-class JAK1 for pruritis, or itching) was approved in the U.S. in May and EU in July. In the U.S., ZTS estimates 8.2M dogs suffer from short or long-term dermatitis-related pruritis, but offered no sales projs. Mgmt. commented on the negative impact of the porcine diarrhea virus on swine sales; we assume this is factored in guidance. Mgmt expects longer term growth to be in-line with or slightly outpace the animal health industry growth rate of 5–7%.

What to watch—easier comps in 3Q. Drought significantly impacted livestock in 3Q:12; management expects strong growth YOY in 3Q:13, given improving climate conditions and lower corn prices. Recall YOY livestock growth in 3Q:12 was -4%. We model 3Q c.c. YOY rev. growth of 5% vs. 4% in 1H:13A. We await mgmt. updates on M&A (bolt-on deals in adjacent areas) and financial action (dividend/ share repurchases).

Key Ratios and Statistics

Reuters: ZTS.N Bloomberg: ZTS US

Specialty Pharmaceuticals / United States of America

Price target	NA
Shr price, close (Aug 6, 2013)	\$31.13
Mkt cap, curr (mm)	\$15,579
52-Week Range	\$35.40-28.97

Fiscal Year ending	12/12	12/13e	12/14e	12/15e
ModelWare EPS (\$)	1.08	1.41	1.67	1.91
Prior ModelWare EPS (\$)	-	1.41	1.66	1.90
P/E	-	22.1	18.6	16.3
Consensus EPS (\$)	1.22	1.40	1.61	1.81

Div yld (%) - 0.8 1.0 1.1

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).

\$ = Consensus data is provided by Thomson Reuters Estimates.

e = Morgan Stanley Research estimates

Quarterly ModelWare EPS

Quarter	2012	2013e	2013e	2014e	2014e
		Prior	Current	Prior	Current
Q1	0.30	-	0.36a	-	-
Q2	0.35	-	0.36a	-	-
Q3	0.31	0.35	0.35	-	-
Q4	0.11	0.35	0.35	-	-

e = Morgan Stanley Research estimates, a = Actual company reported data

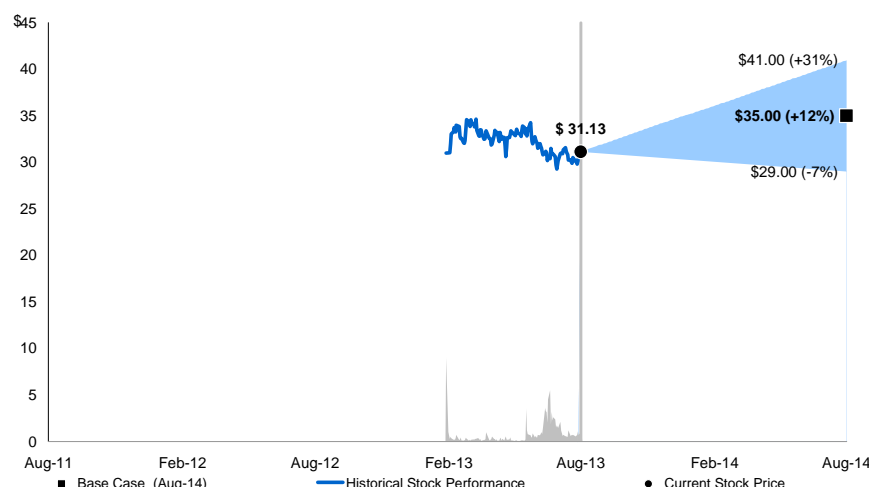
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For analyst certification and other important disclosures, refer to the Disclosure Section, located at the end of this report.

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Risk- Reward Snapshot: Zoetis Inc. (ZTS), Equal-weight

Risk-Reward: We see a balanced risk-reward; earnings upside will dictate potential stock performance



Source: Thomson Reuters, Morgan Stanley Research estimates

Price Target N/A		Valuation based upon 2014E P/E and EV/EBITDA
Bull Case	21.5x Bull Case 14e EPS of \$1.91	Significant earnings upside drives stock outperformance. Our bull case assumes Zoetis can earn in 2014E what we project for 2015E (EBITDA of \$1.6B and EPS of \$1.91). Faster-than- expected realization of margin expansion (bull case '14E O.M. of 27.5% vs. base case '14E O.M. of 25.8%) is a key driver of EPS upside.
Base Case	21x Base Case 14e EPS of \$1.67	We see Zoetis shares as fairly valued on 2014E P/E and EV/ EBITDA. Our base case assumes 4% constant currency YOY rev. growth in '13E accelerating to +7% constant currency in '14E on easier drought-related comps (we est. the drought is a 2% headwind in '13E). Given ZTS' premium multiple on EPS and EBITDA, we believe material earnings upside is necessary for stock outperformance.
Bear Case	19x Bear Case 14e EPS of \$1.53	Bear case assumes margin expansion fails to materialize. Our bear case assumes 2014E EBITDA margins in-line with our 2013E est. of 27.3%. Scarcity value could diminish if free float expands.

Investment Thesis

- Zoetis is a global leader in animal health, and we expect mgmt. to deliver mid-teens EPS growth over the next several years.
- We view ZTS as a compelling alternative to traditional pharma
- But we believe current valuation reflects a balanced risk-reward
- We think material earnings upside is required to drive outperformance beyond these levels

Key Value Drivers

- Operating margin expansion and global business expansion
- Livestock (65% of revs.): Demand for meat and milk is projected to at least double over the next 40 years due in large part to population growth and an increase in affluence in emerging markets (key driver of NT growth)
- Companion Animals (35% of revs): Global spending on pets is growing

Potential Catalysts/ Launches

- U.S. drought developments (we expect conditions to improve in 2H:13)
- China bird flu developments
- Implementation of new antibiotic restrictions and potential for new govt. legislation
- Vet Rx legislation

Investment Risks

- Margin expansion fails to materialize
- Drought persists longer than expected
- Increased govt. antibiotic regulations
- New pharmacy entrants pressure ZTS margins
- SAP implementation

Valuation, Risks, and Comparables

Our **base case** valuation of \$35/share is 21x our 2014E EPS of \$1.67 and 14.7x our 2014E EBITDA of \$1.4B.

ZTS shares currently trade in-line with the highest multiple Large-Cap Growth and SMID-Cap Animal Health companies in our comparables universe. Given Zoetis' premium multiple n EPS and EBITDA, we believe material earnings upside is necessary for stock outperformance.

Upside risks: Bull case assumes significant earnings upside

Our **bull case** assumes Zoetis can earn in 2014E what we project in 2015E (EBITDA of \$1.6B and EPS of \$1.91). Key upside risk is better than expected realization of operating margin expansion. Bull case valuation of \$41 is 21.5x our bull case 2014E EPS of \$1.91 and 15x our bull case 2014E EBITDA of \$1.6B.

Downside risks: Bear case assumes margin expansion fails to materialize

Our **bear case** assumes margin expansion does not materialize (2014E EBITDA margins in-line with 2013E of 27.3%). Bear case valuation of \$29 is 19x our bear case 2014E EPS of \$1.53 and 13x our bear case 2014E EBITDA of \$1.3B.

ZTS has no directs comps; our comps table incl. SMID-Cap Animal Health and Large-Cap Growth Market Leaders

Valuation is a challenge because Zoetis has no publically-traded large cap animal health peer. SMID-cap animal companies are either ex-U.S. (Virbac, Genus, Vetoquinol), closely held (Virbac and Vetoquinol), or more focused on distribution/ vet services (Idexx, VCA, MWI, Genus). Each has a lower EBITDA margin than Zoetis. As a result, we have expanded our comps universe to include Large-Cap Growth companies in other verticals with similar margins and growth outlook as Zoetis. Companies like Monsanto and Syngenta are market leaders in agriculture; Allergan and Novo Nordisk are leaders in healthcare (Botox, store brands, and diabetes respectively); Mead Johnson (split off from Bristol Myers in 2009) is a leader in pediatric nutrition.

Operating margin expansion is expected in out years

Operating leverage in Emerging Markets should support consolidated operating margin expansion.

Segment profitability (by geography) disclosure in Zoetis' earnings filings underscores prospects for operating margin expansion in coming years (we model approx. 200 b.p. annually). According to their filings, Zoetis' U.S. segment is significantly more profitable than the company's operations in Canada/ Latin America (CLAR) and Asia Pacific (APAC). Before corporate overhead, allocated interest expense, and research and development costs managed by ZTS' R&D organization (approx. 25% of total pretax costs), ZTS' U.S. segment had a 52% pretax margin in 2012A. This compares to a 33% pretax margin in CLAR and a 34% pretax margin in APAC.

But as ZTS experiences more robust growth in LatAm and Asia in coming years, greater operating leverage should help close the profitability gap with the U.S. and drive consolidated margin expansion. For example, ZTS has invested significantly in Emerging Markets over the last several years, and mgmt. believes it has the "right" sales infrastructure in place to capture double-digit EM growth without the need to materially increase the size of its sales force.

Exhibit 1

Segment pretax profitability* by geography suggests opportunity in emerging markets like LatAm and China

(%-sales)	2010	2011	2012
U.S.	47%	49%	52%
EuAfME	32%	32%	34%
CLAR	31%	35%	33%
APAC	28%	31%	34%

*Segment pretax profitability excludes corporate overhead, allocated interest expense, and research and development costs managed by ZTS
Notes: EuAfME = Europe, Africa, Middle East, CLAR= Canada, Latin America, APAC= Asia Pacific

Source: Company Data, Morgan Stanley Research

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Exhibit 2

Comparables

(\$USD, millions)							2013E*			2014E*			2013E-2015E CAGR*		EBITDA Margin*	
Ticker	Company Name	Description	Mkt Cap†	Net Debt‡	EV	Div. Yield	EV/ Rev	EV/ EBITDA	P/E	EV/ Rev	EV/ EBITDA	P/E	Revenue	EBITDA	2013E	2014E
Large-Cap Growth																
MON	Monsanto	Agriculture	51,299	-859	50,440	1.6%	3.4x	12.0x	20.7x	3.1x	10.4x	17.9x	8.1%	13.0%	28%	30%
SYT	Syngenta	Agriculture	36,576	2,991	39,567	2.6%	2.6x	12.3x	16.6x	2.5x	10.9x	15.5x	3.3%	4.2%	22%	23%
AGN	Allergan	Botox	27,521	-513	27,008	0.2%	4.3x	12.1x	19.2x	4.0x	10.8x	16.9x	6.4%	9.3%	36%	37%
MJN	Mead Johnson	Infant Formula	15,614	570	16,184	1.8%	3.9x	15.7x	23.6x	3.7x	14.5x	21.5x	7.2%	7.6%	25%	25%
PRGO	Perrigo	Store brands	12,097	1,077	13,174	0.3%	3.7x	14.5x	22.7x	3.2x	12.5x	19.2x	11.0%	14.5%	25%	26%
NOVO B	Novo Nordisk	Diabetes	93,535	-1,972	91,563	1.9%	6.1x	14.8x	20.7x	5.6x	13.3x	18.5x	8.5%	10.1%	41%	42%
Mean						1.4%	4.0x	13.6x	20.6x	3.7x	12.1x	18.2x	7%	10%	30%	31%
SMID-Cap Animal Health																
IDXX	Idexx Laboratories	Diagnostics	5,309	113	5,422	0.0%	3.9x	16.6x	28.2x	3.7x	15.4x	25.3x	N/A	N/A	24%	24%
WOOF	VCA Antech	Vet clinics	2,577	517	3,093	0.0%	1.7x	9.7x	17.3x	1.6x	9.0x	16.3x	9.0%	N/A	18%	18%
VIRP	Virbac (France)	Pharma	1,681	176	1,857	1.3%	1.8x	10.0x	18.5x	1.7x	9.1x	16.5x	8.1%	11.5%	18%	19%
MWIV	MWI Veterinary	Distribution	1,879	11	1,891	0.0%	0.8x	17.6x	30.1x	0.7x	15.3x	26.8x	10.9%	13.6%	5%	5%
GNS	Genus (UK)	Genetics	1,295	98	1,394	1.1%	2.5x	16.7x	25.4x	2.3x	14.9x	22.3x	8.2%	9.7%	15%	16%
VETO	Vetoquinol (France)	Pharma	427	-42	385	1.3%	0.9x	6.7x	13.4x	0.9x	6.3x	12.5x	3.6%	6.1%	14%	14%
Mean						0.6%	2.0x	12.9x	22.2x	1.8x	11.7x	19.9x			16%	16%
Consolidated Mean						1.0%	3.0x	13.2x	21.4x	2.8x	11.9x	19.1x			23%	23%
S&P 500									15.6x			14.7x				
ZTS	Zoetis	Animal pharma	15,793	3,333	19,126	0.8%	4.3x	15.3x	22.4x	4.x	13.4x	18.8x	5%	14%	28%	30%

Source: ThomsonReuters (comparables), Morgan Stanley Research (Zoetis estimates) as of 8/6/13

† Market cap based upon fully diluted share count ‡ Net debt calculated using cash and short-term investments *Based upon consensus estimates

Notes: (1) VIRP and VETO report in Euros, Genus reports in British Pounds, and Novo reports in Danish Kroner; EV calculated using current USD spot rates.

(2) GNS and PRGO fiscal year ends in June, MON FY ends in August, and MWI FY ends in September.

Source: Thomson Reuters, Morgan Stanley Research estimates

Morgan Stanley Research Model

Exhibit 3

Annual Income Statement (1 of 2)

(\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Net revenues	3,582	4,233	4,336	4,471	4,810	5,079
COGS	1,318	1,581	1,549	1,585	1,684	1,752
Gross profit	2,264	2,652	2,787	2,885	3,127	3,327
SG&A	1,365	1,447	1,453	1,382	1,424	1,438
R&D	411	407	399	388	408	420
Amortization of intangibles	17	20	15	15	15	15
Operating income	471	778	920	1,100	1,280	1,454
Other expense (income)	25	28	21	17	25	30
Adjusted EBIT*	496	806	941	1,117	1,305	1,484
Depreciation	86	95	133	115	110	105
EBITDA	599	921	1,089	1,247	1,430	1,604
Other expenses/(income)	12	8	10	100	94	94
Interest expense	37	36	31	117	119	124
Other expense (income)	(25)	(28)	(21)	(17)	(25)	(30)
Pretax income	459	770	910	999	1,186	1,360
Taxes	183	264	372	293	344	394
Tax Rate	39.9%	34.3%	40.9%	29.3%	29.0%	29.0%
Income attributable to non-controlling interest	1	3	-	-	-	-
Net income (Non-GAAP)	275	503	538	706	842	965

DILUTED EPS, proforma	\$0.55	\$1.01	\$1.08	\$1.41	\$1.67	\$1.91
Diluted shares outstanding	500	500	500	501	503	506
Average basic shares outstanding	500	500	500	500	503	505
Period-end basic shares outstanding	500	500	500	500	503	505

*We add back other income in the calc. of EBIT, but exclude from op. income b/c it is not an operating line item

Margin Analysis	2010A	2011A	2012A	2013E	2014E	2015E
COGS	36.8%	37.3%	35.7%	35.5%	35.0%	34.5%
Gross margin	63.2%	62.7%	64.3%	64.5%	65.0%	65.5%
SG&A	38.1%	34.2%	33.5%	30.9%	29.6%	28.3%
R&D	11.5%	9.6%	9.2%	8.7%	8.5%	8.3%
Operating margin	13.1%	18.4%	21.2%	24.6%	26.6%	28.6%
EBIT margin	13.8%	19.0%	21.7%	25.0%	27.1%	29.2%
D&A	2.9%	2.7%	3.4%	2.9%	2.6%	2.4%
EBITDA margin	16.7%	21.8%	25.1%	27.9%	29.7%	31.6%
Pretax margin	12.8%	18.2%	21.0%	22.4%	24.7%	26.8%
Net margin	7.7%	11.9%	12.4%	15.8%	17.5%	19.0%

Source: Company Data, Morgan Stanley Research

Exhibit 4

Income Statement (2 of 2)

YOY % Change	2010A	2011A	2012A	2013E	2014E	2015E
Net revenues	30%	18%	2%	3%	8%	6%
COGS	32%	20%	-2%	2%	6%	4%
Gross profit	29%	17%	5%	4%	8%	6%
SG&A	29%	6%	0%	-5%	3%	1%
R&D	13%	-1%	-2%	-3%	5%	3%
Operating income	47%	65%	18%	20%	16%	14%
<i>EBIT</i>	54%	62%	17%	19%	17%	14%
<i>EBITDA</i>	65%	54%	18%	14%	15%	12%
Pretax income	55%	68%	18%	10%	19%	15%
Net income (Non-GAAP)	46%	83%	7%	31%	19%	15%
DILUTED EPS, proforma	46%	83%	7%	31%	19%	14%
Diluted shares outstanding	0%	0%	0%	0%	1%	1%

Source: Company Data, Morgan Stanley Research

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Exhibit 5

Quarterly Income Statement

(\$M)	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A	3Q:13E	4Q:13E	2013E
Net revenues	1,047	1,094	1,018	1,176	4,336	1,090	1,114	1,062	1,204	4,471
COGS	388	382	352	427	1,549	398	400	372	416	1,585
Gross profit	659	712	666	749	2,787	692	714	690	789	2,885
SG&A	331	351	330	441	1,453	322	339	320	401	1,382
R&D	93	91	94	121	399	90	91	96	111	388
Amortization of intangibles	4	3	4	4	15	4	3	4	4	15
Operating income	231	267	238	183	920	276	281	270	272	1,100
Other expense (income)	6	7	10	(2)	21	(2)	3	8	8	17
Adjusted EBIT*	237	274	248	181	941	274	284	278	280	1,117
Depreciation	19	33	41	40	133	35	27	27	27	115
EBITDA	260	310	293	225	1,089	313	314	309	311	1,247
Other expenses/(income)	2	1	(3)	10	10	24	29	24	24	100
Interest expense	8	8	7	8	31	22	32	32	32	117
Other expense (income)	(6)	(7)	(10)	2	(21)	2	(3)	(8)	(8)	(17)
Pretax income	229	266	241	173	910	252	252	247	249	999
Taxes	76	90	89	117	372	73	74	72	75	293
Tax Rate	33.2%	33.8%	36.9%	67.5%	40.9%	29.0%	29.4%	29.0%	30.0%	29.3%
Income attributable to non-controlling int	1	-	(1)	-	-	-	-	-	-	-
Net income (Non-GAAP)	152	176	153	56	538	179	178	175	174	706
DILUTED EPS, proforma	\$0.30	\$0.35	\$0.31	\$0.11	\$1.08	\$0.36	\$0.36	\$0.35	\$0.35	\$1.41
Diluted shares outstanding	500	500	500	500	500	500	500	501	501	501
Margin Analysis	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A	3Q:13E	4Q:13E	2013E
COGS	37.1%	34.9%	34.6%	36.3%	35.7%	36.5%	35.9%	35.0%	34.5%	35.5%
Gross margin	62.9%	65.1%	65.4%	63.7%	64.3%	63.5%	64.1%	65.0%	65.5%	64.5%
SG&A	31.6%	32.1%	32.4%	37.5%	33.5%	29.5%	30.4%	30.1%	33.3%	30.9%
R&D	8.9%	8.3%	9.2%	10.3%	9.2%	8.3%	8.2%	9.0%	9.2%	8.7%
Operating margin	22.1%	24.4%	23.4%	15.6%	21.2%	25.3%	25.2%	25.5%	22.6%	24.6%
EBIT margin	22.6%	25.0%	24.4%	15.4%	21.7%	25.1%	25.5%	26.2%	23.3%	25.0%
D&A	2.2%	3.3%	4.4%	3.7%	3.4%	3.6%	2.7%	2.9%	2.5%	2.9%
EBITDA margin	24.8%	28.3%	28.8%	19.2%	25.1%	28.7%	28.2%	29.1%	25.8%	27.9%
Pretax margin	21.9%	24.3%	23.7%	14.7%	21.0%	23.1%	22.6%	23.2%	20.6%	22.4%
Net margin	14.5%	16.1%	15.1%	4.8%	12.4%	16.4%	16.0%	16.5%	14.4%	15.8%
YOY % Change	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A	3Q:13E	4Q:13E	2013E
Net revenues	6%	2%	-3%	4%	2%	4%	2%	4%	2%	3%
COGS	5%	-11%	-10%	8%	-2%	3%	5%	6%	-3%	2%
Gross profit	7%	10%	1%	3%	5%	5%	0%	4%	5%	4%
SG&A	-1%	-2%	0%	4%	0%	-3%	-3%	-3%	-9%	-5%
R&D	-6%	-9%	-4%	10%	-2%	-3%	0%	2%	-8%	-3%
Operating income	31%	46%	5%	-4%	18%	19%	5%	13%	48%	20%
EBIT	29%	47%	6%	-10%	17%	16%	4%	12%	54%	19%
EBITDA	20%	44%	8%	4%	18%	20%	1%	5%	38%	14%
Pretax income	31%	50%	7%	-10%	18%	10%	-5%	2%	43%	10%
Net income (Non-GAAP)	25%	55%	5%	-54%	7%	18%	1%	14%	208%	31%
DILUTED EPS, proforma	26%	55%	5%	-54%	7%	18%	1%	14%	208%	31%
Diluted shares outstanding	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Source: Company Data, Morgan Stanley Research

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Exhibit 6

Management Reported Segment Profitability (1 of 2)

(\$M)	2010A	2011A	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A
Revenues	3,582	4,233	1,047	1,094	1,019	1,176	4,336	1,090	1,114
U.S.	1,384	1,659	425	421	448	482	1,776	454	437
EuAfME	1,020	1,144	275	283	241	297	1,096	290	278
CLAR	664	788	173	211	165	220	769	171	213
APAC	514	642	174	179	165	177	695	175	186
Segment Pretax Earnings (pre-corp)*	1,333	1,656	446	455	435	449	1,785	478	494
U.S.	656	820	217	227	232	245	921	234	254
EuAfME	328	365	104	88	91	92	375	117	91
CLAR	203	275	54	77	53	69	253	52	78
APAC	146	196	71	63	59	43	236	75	71
Other business activities**	(264)	(279)	(65)	(61)	(65)	(84)	(275)	(74)	(74)
Corporate†	(533)	(504)	(129)	(104)	(113)	(160)	(506)	(116)	(137)
Other unallocated‡	(77)	(103)	(23)	(24)	(15)	(31)	(93)	(36)	(96)
Consolidated Pre-tax income	459	770	229	266	242	174	911	252	187
Margin Analysis	2010A	2011A	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A
Segment Pretax Earnings (pre-corp)*	37%	39%	43%	42%	43%	38%	41%	44%	44%
U.S.	47%	49%	51%	54%	52%	51%	52%	52%	58%
EuAfME	32%	32%	38%	31%	38%	31%	34%	40%	33%
CLAR	31%	35%	31%	36%	32%	31%	33%	30%	37%
APAC	28%	31%	41%	35%	36%	24%	34%	43%	38%
Other business activities**	-7%	-7%	-6%	-6%	-6%	-7%	-6%	-7%	-7%
Corporate†	-15%	-12%	-12%	-10%	-11%	-14%	-12%	-11%	-12%
Other unallocated‡	-2%	-2%	-2%	-2%	-1%	-3%	-2%	-3%	-9%
Consolidated Pre-tax income	13%	18%	22%	24%	24%	15%	21%	23%	17%

Source: Company Data, Morgan Stanley Research\

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Exhibit 7

Management Reported Segment Profitability (2 of 2)

YOY % Change	2010A	2011A	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A
Revenues	30%	18%	7%	2%	-3%	4%	2%	4%	2%
U.S.	25%	20%	12%	8%	2%	7%	7%	7%	4%
EuAfME	16%	12%	-2%	-4%	-12%	1%	-4%	5%	-2%
CLAR	47%	19%	2%	-2%	-8%	-1%	-2%	-1%	1%
APAC	59%	25%	15%	5%	4%	9%	8%	1%	4%
Segment Pretax Earnings (pre-corp)*	23%	24%	11%	14%	0%	6%	8%	7%	9%
U.S.	24%	25%	23%	18%	1%	11%	12%	8%	12%
EuAfME	4%	11%	-6%	11%	-3%	14%	3%	13%	3%
CLAR	33%	35%	-7%	13%	-18%	-18%	-8%	-4%	1%
APAC	64%	34%	27%	7%	34%	16%	20%	6%	13%
Other business activities**	18%	6%	-8%	-9%	-12%	25%	-1%	14%	21%
Corporate†	7%	-5%	-4%	-18%	5%	19%	0%	-10%	32%
Other unallocated‡	10%	34%	5%	-11%	-42%	11%	-10%	57%	300%
Consolidated Pre-tax income	55%	68%	31%	49%	8%	-9%	18%	10%	-30%
Segment Contributor Analysis	2010A	2011A	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A
Revenues									
U.S.	39%	39%	41%	38%	44%	41%	41%	42%	39%
EuAfME	28%	27%	26%	26%	24%	25%	25%	27%	25%
CLAR	19%	19%	17%	19%	16%	19%	18%	16%	19%
APAC	14%	15%	17%	16%	16%	15%	16%	16%	17%
Segment Pretax Earnings (pre-corp)*									
U.S.	49%	50%	49%	50%	53%	55%	52%	49%	51%
EuAfME	25%	22%	23%	19%	21%	20%	21%	24%	18%
CLAR	15%	17%	12%	17%	12%	15%	14%	11%	16%
APAC	11%	12%	16%	14%	14%	10%	13%	16%	14%

Footnotes

* Defined as income/ (loss) before provision/ (benefit)for taxes on income

** Other business activities reflect the R&D costs managed by ZTS' Research and Development organization (not equal to 100% of consolidated R&D on the I/S)

† Corporate includes, among other things, administration expenses, allocated interest expense, certain compensation, and other costs not charged to operating segments.

‡ Includes overhead expenses associated with ZTS's manufacturing operations

Source: Company Data, Morgan Stanley Research

Exhibit 8

Annual Revenue (1 of 2)

(\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Total Revenue	3,582	4,233	4,336	4,471	4,810	5,079
Base revenue	2,968	3,821	4,445	4,526	4,786	5,079
Fx impact	69	104	(146)	(55)	24	-
Acquisitions	640	329	37	-	-	-
Divestitures	(95)	(21)	-	-	-	-
United States (U.S.)	1,384	1,659	1,776	1,867	2,017	2,118
Base revenue	1,250	1,473	1,762	1,867	2,017	2,118
Acquisitions	147	186	14	-	-	-
Divestitures	(13)	-	-	-	-	-
Europe/Africa/Middle East (EuAfME)	1,020	1,144	1,096	1,108	1,163	1,210
Total Base revenue	871	1,051	1,165	1,115	1,163	1,210
Fx impact	(6)	34	(77)	(7)	-	-
Acquisitions	229	59	8	-	-	-
Divestitures	(74)	-	-	-	-	-
Canada/Latin America (CLAR)	664	788	769	788	844	894
Base revenue	474	720	823	806	835	894
Fx impact	44	28	(61)	(18)	8	-
Acquisitions	146	49	7	-	-	-
Divestitures	-	(9)	-	-	-	-
Asia Pacific (APAC)	514	642	695	707	786	857
Base revenue	373	577	695	738	771	857
Fx impact	31	42	(8)	(30)	15	-
Acquisitions	118	35	8	-	-	-
Divestitures	(8)	(12)	-	-	-	-

Source: Company Data, Morgan Stanley Research

Exhibit 9

Annual Revenue (2 of 2)

YOY % CHANGE	2010A	2011A	2012A	2013E	2014E	2015E
Total Revenue	30%	18%	2%	3%	8%	6%
Base revenue	8%	7%	5%	4%	7%	6%
Fx impact	2%	3%	-3%	-1%	0%	0%
Acquisitions	23%	9%	1%	NM	NM	NM
Divestitures	-3%	-1%	0%	NM	NM	NM
United States (U.S.)	25%	20%	7%	5%	8%	5%
Base revenue	13%	6%	6%	5%	8%	5%
Acquisitions	13%	13%	1%	NM	NM	NM
Divestitures	-1%	0%	0%	NM	NM	NM
Europe/Africa/Middle East (EuAfME)	16%	12%	-4%	1%	5%	4%
Base revenue	-1%	3%	2%	2%	5%	4%
Fx impact	-1%	3%	-7%	-1%	0%	0%
Acquisitions	26%	6%	1%	NM	NM	NM
Divestitures	-8%	0%	0%	NM	NM	NM
Canada/Latin America (CLAR)	47%	19%	-2%	2%	7%	6%
Base revenue	5%	8%	4%	5%	6%	6%
Fx impact	10%	4%	-7%	-2%	1%	0%
Acquisitions	32%	7%	1%	NM	NM	NM
Divestitures	0%	-1%	0%	NM	NM	NM
Asia Pacific (APAC)	59%	25%	8%	2%	11%	9%
Base revenue	15%	12%	8%	6%	9%	9%
Fx impact	10%	8%	-1%	-4%	2%	0%
Acquisitions	36%	7%	1%	NM	NM	NM
Divestitures	-2%	-2%	0%	NM	NM	NM

Source: Company Data, Morgan Stanley Research

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Exhibit 10

Historical and Projected Revenues by Species

Revenue by Species (\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Livestock	2,233	2,778	2,806	2,866	3,103	3,276
Cattle	1,464	1,617	1,608			
Swine	433	562	590			
Poultry	265	501	501			
Other (Fish and Sheep)	71	98	107			
U.S.						
EuAfME						
CLAR						
APAC						
Companion Animal	1,349	1,455	1,530	1,604	1,708	1,803
Horses	159	168	187			
Dogs and Cats	1,190	1,287	1,343			
U.S.						
EuAfME						
CLAR						
APAC						
YOY % CHANGE	2010A	2011A	2012A	2013E	2014E	2015E
Livestock	32%	24%	1%	2%	8%	6%
Cattle	30%	10%	-1%			
Swine	12%	30%	5%			
Poultry	112%	89%	0%			
Other (Fish and Sheep)	51%	38%	9%			
U.S.						
EuAfME						
CLAR						
APAC						
Companion Animal	26%	8%	5%	5%	6%	6%
Horses	99%	6%	11%			
Dogs and Cats	20%	8%	4%			

Source: Company Data, Morgan Stanley Research

Exhibit 11

Segment Revenue Breakdown

% of total revenue	2010A	2011A	2012A	2013E	2014E	2015E
United States (U.S.)	39%	39%	41%	42%	42%	42%
Europe/Africa/Middle East (EuAfME)	28%	27%	25%	25%	24%	24%
Canada/Latin America (CLAR)	19%	19%	18%	18%	18%	18%
Asia Pacific (APAC)	14%	15%	16%	16%	16%	17%
Livestock	62.3%	65.6%	64.7%	64.1%	64.5%	64.5%
U.S.						
EuAfME						
CLAR						
APAC						
Companion Animal	37.7%	34.4%	35.3%	35.9%	35.5%	35.5%

Source: Company Data, Morgan Stanley Research

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Zoetis Inc.

Exhibit 12

Quarterly Revenue

(\$M)	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A	3Q:13E	4Q:13E	2013E
Total Revenue	1,047	1,094	1,018	1,176	4,336	1,090	1,114	1,062	1,204	4,471
Base revenue	1,024	1,137	1,081	1,203	4,445	1,097	1,135	1,073	1,221	4,526
Fx impact	(14)	(43)	(63)	(27)	(146)	(7)	(21)	(11)	(17)	(55)
United States (U.S.)	425	420	448	483	1,776	454	437	479	497	1,867
Base revenue	412	420	448	483	1,762	454	437	479	497	1,867
Europe/Africa/Middle East (EuAfME)	275	283	241	297	1,096	290	278	243	297	1,108
Total Base revenue	277	305	272	311	1,165	286	286	243	300	1,115
Fx impact	(10)	(22)	(31)	(14)	(77)	4	(8)	-	(3)	(7)
Canada/Latin America (CLAR)	173	211	165	220	769	171	213	174	231	788
Base revenue	172	230	188	233	823	179	220	174	233	806
Fx impact	(6)	(19)	(23)	(13)	(61)	(8)	(7)	-	(2)	(18)
Asia Pacific (APAC)	174	179	165	177	695	175	186	166	180	707
Base revenue	164	182	173	177	695	177	192	177	191	738
Fx impact	2	(2)	(8)	1	(8)	(2)	(6)	(11)	(11)	(30)
YOY % CHANGE	1Q:12A	2Q:12A	3Q:12A	4Q:12A	2012A	1Q:13A	2Q:13A	3Q:13E	4Q:13E	2013E
Total Revenue	6%	2%	-3%	4%	2%	4%	2%	4%	2%	3%
Base revenue	4%	6%	3%	7%	5%	5%	4%	5%	4%	4%
Fx impact	-1%	-4%	-6%	-2%	-3%	-1%	-2%	-1%	-1%	-1%
Acquisitions	4%	0%	0%	0%	1%	0%	0%	0%	0%	NM
Divestitures	0%	0%	0%	0%	0%	0%	0%	0%	0%	NM
United States (U.S.)	12%	7%	2%	7%	7%	7%	4%	7%	3%	5%
Base revenue	8%	7%	2%	7%	6%	7%	4%	7%	3%	5%
Europe/Africa/Middle East (EuAfME)	-2%	-4%	-12%	1%	-4%	5%	-2%	1%	0%	1%
Base revenue	-2%	3%	0%	6%	2%	4%	1%	1%	1%	2%
Fx impact	-3%	-7%	-12%	-5%	-7%	1%	-3%	0%	-1%	-1%
Acquisitions	3%	0%	0%	0	1%	NM	NM	NM	NM	NM
Divestitures	0%	0%	0%	0	0%	NM	NM	NM	NM	NM
Canada/Latin America (CLAR)	2%	-2%	-8%	-1%	-2%	-1%	1%	5%	5%	2%
Base revenue	2%	6%	4%	4%	4%	4%	4%	5%	6%	5%
Fx impact	-4%	-8%	-12%	-6%	-7%	-5%	-3%	0%	-1%	-2%
Asia Pacific (APAC)	15%	5%	4%	9%	8%	1%	4%	1%	2%	2%
Base revenue	8%	6%	9%	9%	8%	2%	7%	8%	8%	6%
Fx impact	1%	-1%	-5%	0%	-1%	-1%	-3%	-6%	-6%	-4%

Source: Company Data, Morgan Stanley Research

Exhibit 13

Cash flow statement

(\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Net income (Non-GAAP)	275	503	538	706	842	965
GAAP adjustments	(164)	(255)	(102)	(175)	(100)	(75)
Net income before minority interest (GAAP)	111	248	436	531	742	890
Depreciation & amortization	185	205	200	185	180	175
Depreciation	86	95	133	115	110	105
Amortization	99	110	67	70	70	70
Change in operating assets and liabilities	100	(117)	(149)	(113)	(24)	(80)
Other operating activities	(142)	161	(33)	(89)	90	-
Net cash from operating activities	254	497	454	514	988	986
Purchase of PP&E	(124)	(135)	(126)	(150)	(150)	(150)
Other investing activities	115	(314)	(9)	-	-	-
Net cash from investing activities	(9)	(449)	(135)	(150)	(150)	(150)
Cash dividends paid	(207)	(416)	(63)	(3,780)	(150)	(174)
Net change in short-term debt	-	-	-	-	-	-
Net change in long-term debt	-	(143)	-	3,650	-	-
Acquisitions, share repurchases, other	(70)	529	(15)	-	-	-
Net cash from financing activities	(277)	(30)	(78)	(130)	(150)	(174)
Effect of exchange rates	(4)	(2)	(3)	-	-	-
Net increase in cash	(36)	16	238	234	688	662
Cash at beginning of period	99	63	79	317	551	1,239
Cash at end of period	63	79	317	551	1,239	1,902

Source: Company Data, Morgan Stanley Research

Exhibit 14

Balance Sheet

(\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Cash and short-term investments	63	79	317	551	1,239	1,902
Receivables	773	871	900	982	1,022	1,094
Inventories	995	1,063	1,345	1,191	1,359	1,256
Other current assets	285	298	302	300	300	300
Current assets	2,116	2,311	2,864	3,025	3,921	4,552
Net property, plant and equipment	1,148	1,243	1,241	1,276	1,316	1,361
Other assets	2,020	2,157	2,157	2,087	2,017	1,947
Total Assets	5,284	5,711	6,262	6,388	7,254	7,860
Short-term debt	38	-	73	-	-	-
Accounts Payable	206	214	319	214	347	237
Other current liabilities	564	629	731	650	700	700
Current liabilities	808	843	1,123	864	1,047	937
Long-term debt	673	575	509	3,650	3,650	3,650
Other liabilities	459	557	589	500	590	590
Total Liabilities	1,940	1,975	2,221	5,014	5,287	5,177
Preferred stock	-	-	-	-	-	-
Common Equity	3,344	3,720	4,026	1,359	1,951	2,668
Minority Interest	-	16	15	15	15	15
Shareholders' Equity	3,344	3,736	4,041	1,374	1,966	2,683
Total Liabilities and SE	5,284	5,711	6,262	6,388	7,254	7,860

Source: Company Data, Morgan Stanley Research

Exhibit 15

Capital Structure

	2010A	2011A	2012A	2013E	2014E	2015E
Capital structure						
Net debt	648	496	265	3,099	2,411	1,748
Net debt-to-equity	0.2	0.1	0.1	2.3	1.2	0.7
Net Debt to Capital	16.0%	11.5%	5.7%	61.7%	42.9%	27.6%
Total Debt	711	575	582	3,650	3,650	3,650
Total Debt to Capital	17.5%	13.3%	12.6%	72.6%	65.0%	57.6%
Total Debt to EBITDA (current year)	1.2x	0.6x	0.5x	2.9x	2.6x	2.3x
Net Debt to EBITDA (current year)	1.1x	0.5x	0.2x	2.5x	1.7x	1.1x
Interest coverage ratio	(13)	(22)	(30)	(10)	(11)	(12)
Interest expense	(37)	(36)	(31)	(117)	(119)	(124)
Dividend payout ratio	75%	83%	12%	535%	18%	18%
Dividend per share	\$0.41	\$0.83	\$0.13	\$0.26	\$0.30	\$0.34
Dividend growth	105%	101%	-85%	NM	15%	15%

Source: Company Data, Morgan Stanley Research

Exhibit 16

Financial Metrics

(\$M)	2010A	2011A	2012A	2013E	2014E	2015E
Operating efficiency						
Accounts receivable turnover	4.6x	5.1x	4.9x	4.8x	4.8x	4.8x
Inventory turnover	1.3x	1.5x	1.3x	1.3x	1.3x	1.3x
Accounts payable turnover	6.4x	7.5x	5.8x	6.0x	6.0x	6.0x
Fixed asset turnover	3.1x	3.5x	3.5x	3.6x	3.7x	3.8x
Capex as % sales	3.5%	3.2%	2.9%	3.4%	3.1%	3.0%
Depreciation to fixed assets ratio		0.08x	0.11x	0.09x	0.09x	0.08x
Days sales outstanding	79	71	75	77	76	76
Days payables outstanding	57	48	63	61	61	61
Days inventory held	276	238	284	292	277	272
Cash conversion cycle (days)	297	260	295	307	292	288
Liquidity						
Working capital	1,308	1,468	1,741	2,161	2,873	3,615
Current ratio	2.6	2.7	2.6	3.5	3.7	4.9
Quick ratio	1.4	1.5	1.4	2.1	2.4	3.5
Cash ratio	0.1	0.1	0.3	0.6	1.2	2.0
Profitability						
Adjusted EPS	\$0.55	\$1.01	\$1.08	\$1.41	\$1.67	\$1.91
GAAP EPS	\$0.22	\$0.50	\$0.87	\$1.06	\$1.48	\$1.76
GAAP vs adjusted	(\$0.33)	(\$0.51)	(\$0.20)	(\$0.35)	(\$0.20)	(\$0.15)
Adjusted EBIT*	\$496	\$806	\$941	\$1,117	\$1,305	\$1,484
Adjusted EBITDA	\$599	\$921	\$1,089	\$1,247	\$1,430	\$1,604
Operating cash flow per share	\$0.94	\$1.43	\$1.49	\$1.92	\$2.16	\$2.39
FCF per share	\$0.11	\$0.56	\$0.56	\$0.93	\$1.52	\$1.69
OCF	468	716	744	962	1,089	1,207
FCF	54	279	279	466	763	854
FCF less dividends	(153)	(137)	216	(3,314)	612	680
FCF less dividends/share buybacks	(156)	(137)	216	(3,314)	612	680
Book value per share	\$6.69	\$7.47	\$8.08	\$2.75	\$3.91	\$5.31
Return on asset/equity						
EBT margin	12.8%	18.2%	21.0%	22.4%	24.7%	26.8%
ROA	24.0%	42.1%	43.3%	56.1%	65.0%	72.1%
Leverage (assets/equity)	1.6	1.6	1.5	2.3	4.1	3.3
Tax effect	60.1%	65.7%	59.1%	70.7%	71.0%	71.0%
ROE	8.2%	13.5%	13.3%	51.4%	42.8%	36.0%
ROIC				15.6%	18.3%	20.6%
NOPAT				777	909	1,032
Invested Capital (Assets- Cash- Current Liabilities)				4,973	4,967	5,021

Source: Company data, Morgan Stanley Research estimates

Exhibit 17

Footnotes

2Q:13A

- **Constant currency revenue growth:** Total +4%, U.S. +4%, EUAfME +1%, CLAR +4%, APAC +7%
- **U.S.:** Companion animal growth of +2% YOY was positively impacted by a competitor's supply disruption. Livestock was up 6% YOY; poultry and swine offset declines in cattle due to drought.
- **EUafME:** Unseasonably cold spring negatively impacted growth in livestock and companion animal segments.
- **CLAR:** Companion animal growth was 6% YOY, despite somewhat tougher comps in Canada (competitor faced a supply disruption last year).
- **APAC:** Growth driven by launch of new products, slightly offset by drought in Australia and New Zealand

1Q:13A

- **Constant currency revenue growth:** Total +5%, U.S. +7%, EUafME +4%, CLAR +4%, APAC +2%
- **U.S.:** Companion animal growth of +13% YOY was positively impacted by a competitor's supply disruption. Livestock was up 7% YOY; poultry and swine offset declines in cattle due to drought.
- **EUafME:** Timing of price increases positively impacted growth (last year ZTS raised prices in 2Q instead of 1Q)
- **CLAR:** Companion animal was down 5% YOY on tougher companion animal comps in Canada (competitor faced a supply disruption last year).
- **APAC:** Headwinds included drought in Australia, macroeconomic weakness in Japan and Korea, and regulatory delays in India.

4Q:12A

- **U.S. Organic Growth:** +7% YOY offset light 3Q:12 (+3%). Farmers kept herds on pasture longer in 3Q (farmers may have been holding out for rain/higher beef prices), which resulted in a bolus of demand in feedlots in 4Q)
- **CLAR:** Drought (primarily in Northern Mexico) negatively impacted cattle sales, which also had a negative impact on segment margins (cattle are among the most profitable livestock animals)
- **Abnormally high SG&A**
 - Seasonality
 - Costs associated with buildup of internal capabilities
 - "Dis-"synergies: Higher than expected corporate overhead costs (PFE switched cost allocation from %-of sales to actual costs)
- **EUafME:** Strength in emerging markets (e.g., Africa, Russia, Turkey) offset continued macroeconomic weakness in Western Europe
- **Inventories:** Mgmt. built in safety stock in advance of shifting over internal systems
- **67.5% tax rate:** 10K notes: "tax costs related to uncertain tax positions, substantially all of which will remain with Pfizer and to a lesser extent, tax costs associated with repatriation decisions among other impacts."

Source: Company Data, Morgan Stanley Research

Exhibit 18

Management Guidance

For period	2013	2013
Date provided	4/30/2012	8/6/2013
Revenue	\$4,425-\$4,525	\$4,425-\$4,525
COGS (% of sales)	35-36%	35-36%
SG&A	\$1,385-\$1,435	\$1,385-\$1,435
R&D	\$385-\$415	\$385-\$415
Interest expense	~115M	~115M
Other (income)/expenses	~(20M)	~(20M)
Tax rate	~29.5%	~29.5%
Net income (Non-GAAP)	~\$680M-\$710M	~\$680M-\$710M
Adjusted Diluted EPS	\$1.36-\$1.42	\$1.36-\$1.42

Source: Company Data

August 7, 2013

Zoetis Inc.



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(as of July 31, 2013)

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1009	35%	410	39%	41%
Equal-weight/Hold	1302	45%	496	47%	38%
Not-Rated/Hold	112	4%	27	3%	24%
Underweight/Sell	467	16%	123	12%	26%
Total	2,890		1056		

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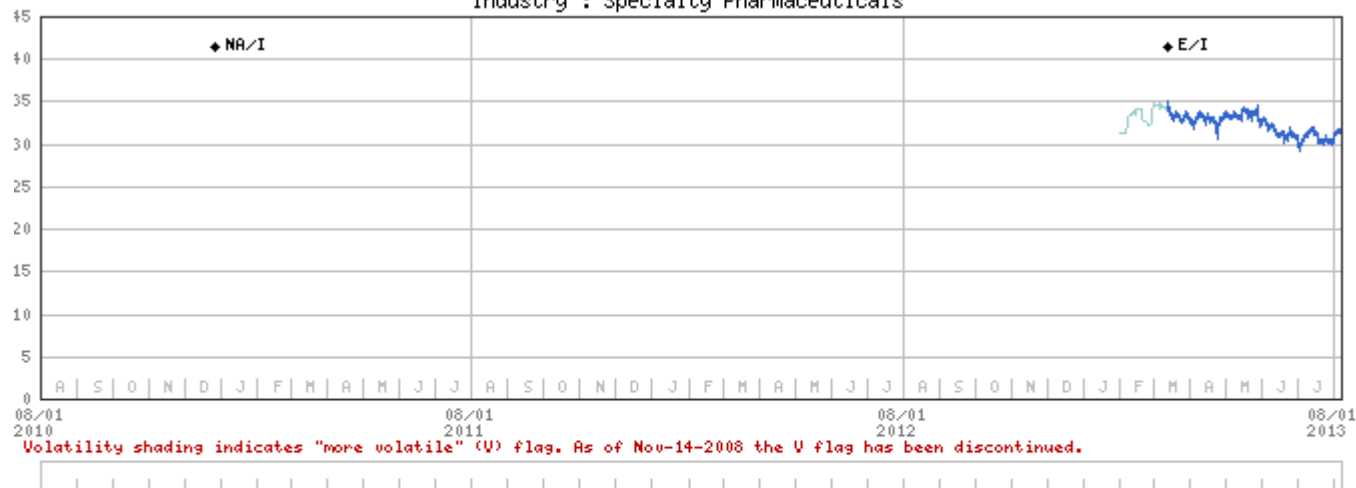
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Stock Price, Price Target and Rating History (See Rating Definitions)

August 7, 2013

Zoetis Inc.

Zoetis Inc. (ZTS.N) - As of 8/6/13 in USD
Industry : Specialty Pharmaceuticals



Stock Rating History: 12/26/10 : NA/I; 3/13/13 : E/I

Price Target History: 3/13/13 : NA

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Industry Coverage: Specialty Pharmaceuticals

Company (Ticker)	Rating (as of)	Price* (08/06/2013)
Christopher Caponetti		
Endo Health Solutions Inc (ENDP.O)	E (07/24/2013)	\$37.47
David Friedman, M.D.		
Sagent Pharmaceuticals Inc (SGNT.O)	E (08/13/2012)	\$21.88
David Risinger		
Actavis Inc (ACT.N)	O (01/25/2012)	\$135.62
Alkermes Plc. (ALKS.O)	O (01/10/2013)	\$34.33
Allergan Inc. (AGN.N)	E (05/01/2013)	\$90.84
Forest Laboratories Inc. (FRX.N)	E (04/26/2011)	\$44.34
Mylan Inc. (MYL.O)	O (08/02/2013)	\$36.82
Perrigo Co. (PRGO.N)	++	\$127.89
Teva Pharmaceutical Industries Ltd. (TEVA.N)	U (08/05/2013)	\$38.45
Valeant Pharmaceuticals International (VRX.N)	E (09/14/2012)	\$95.72
Warner Chilcott Plc (WCRX.O)	E (05/13/2013)	\$21.54
Zoetis Inc. (ZTS.N)	E (08/07/2013)	\$31.13

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