

Morgan Stanley & Co. LLC

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November 5, 2013

Stock Rating
Overweight

Industry View
In-Line

Zoetis Inc.

3Q rev upside offset by costs; guidance midpts up slightly

3Q revs above; EPS \$0.01 below our est but in line with consensus. 3Q revs. of \$1.10B were 4% above our and cons' \$1.06B. Reported growth was up 8% YOY (constant currency +9% YOY, FX -1%). U.S. and EuAfME were above our ests., CLAR was slightly below and APAC was roughly in-line. 3Q EPS of \$0.34 were 2% below our \$0.35 but in-line with cons' \$0.34. \$0.01 EPS downside vs. our model included (sum differs due to rounding): Revenues +\$0.06; COGS -\$0.02; SG&A -\$0.05; R&D +\$0.01. **See tables on following pages.**

2013 Guidance: low-end of EPS and revenue ranges bumped up; top-ends maintained: Total revenue guidance is now \$4.475–4.525B (previously was \$4.425–4.525B). Midpoint of \$4.50B (up <1% vs. previous midpt of \$4.475B) is slightly above our \$4.47B and cons' \$4.49B. EPS range is now \$1.38–1.42 (previously was \$1.36–1.42). Midpoint of \$1.40 (up <1% vs. previous midpt of \$1.39) is 1% below our \$1.41 and in-line with cons' \$1.40.

Segment details vs. our projections: U.S. revenues of \$495M were 3% above with our \$479M. U.S. livestock were up 11% YOY and companion animal was up 10% YOY. EuAfME revenues of \$270M were 11% above our \$243M. Constant currency growth was +9% YOY and FX was a 3% tailwind. CLAR revenues of \$171M were 1% below our \$174M. Constant currency YOY growth was +9%; FX was a 5% headwind. APAC revenues of \$167M were in-line with our \$166M. Constant currency YOY growth was +7% YOY; FX was a 6% headwind.

Solid results should boost investor confidence in Zoetis' growth prospects; we expect ZTS shares to sustain the current multiple on 2014E EPS through '15E. Our \$36 PT is 19x our 2015E EPS of \$1.91. This is roughly in-line with the current multiple on our 2014E EPS of \$1.67. We have confidence in 3-yr mid-single digit rev and low-to-mid teens EPS growth.

Key Ratios and Statistics

Reuters: ZTS.N Bloomberg: ZTS US

Specialty Pharmaceuticals / United States of America

Shr price, close (Nov 4, 2013)	\$31.93
Mkt cap, curr (mm)	\$15,979
52-Week Range	\$35.40-28.81

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Zoetis Inc.

Exhibit 1

Zoetis 3Q:13 Income Statement Variation (YOY)

	Actual		MS Estimate		Variation vs. MS Est.			CONS. est.		Variation vs. CONS.		Actual
(\$M)	3Q:13A	YOY % Chg.	3Q:13E	YOY % Chg.	Absolute	Pct	EPS Impact	3Q:13E	Absolute	Pct	3Q:12A	
Net revenues	1,103	8%	1,062	4%	41	4%	+0.06	1,063	40	4%	1,018	
COGS	383	9%	372	6%	11	3%	-0.02				352	
Gross profit	720	8%	690	4%	30	4%	+0.04	696	24	3%	666	
SG&A	359	9%	320	-3%	39	12%	-0.05	331	29	9%	330	
R&D	91	-3%	96	2%	(5)	-5%	+0.01	96	(5)	-6%	94	
Amortization of intangibles	4	0%	4	0%	-	0%	+0.00				4	
Operating income	266	12%	270	13%	(4)	-2%	-0.01	270	(4)	-2%	238	
Other expenses/(income)	22	-833%	24	-890%	(2)	-7%	+0.00				(3)	
Interest expense	29	314%	32	353%	(3)	-9%					7	
Other expense (income)	(7)	-30%	(8)	-20%	1	-13%					(10)	
Pretax income	244	1%	247	2%	(3)	-1%	-0.00	241	3	1%	241	
Taxes	72	-19%	72	-20%	0	1%	-0.00				89	
Tax Rate	29.5%	-20%	29.0%	-21%	0.5%	2%					36.9%	
Income attributable to non-controlling interest	-	-100%	-	-100%	-	*	+0.00				(1)	
Net income (Non-GAAP)	172	12%	175	14%	(3)	-2%	-0.01	170	2	1%	153	
DILUTED EPS, proforma	\$0.34	12%	\$ 0.35	14%	(\$0.01)	-2%		\$0.34	\$0.00	1%	\$ 0.31	
Diluted shares outstanding	500	0%	501	0%	(1)	0%					500	

*\$0.01 per share equates to approximately \$7.1M pretax

Margin Analysis	Actual		MS Estimate		Variation (b.p.)		CONS.			Actual
	3Q:13A		3Q:13E		vs. MS est.	vs. 3Q:12A	3Q:13E	Variation (b.p.)		3Q:12A
COGS	34.7%		35.0%		(28)	16				34.6%
Gross margin	65.3%		65.0%		28	(16)	65.5%	(20)	0%	65.4%
SG&A	32.5%		30.1%		241	15				32.4%
R&D	8.3%		9.0%		(78)	(98)				9.2%
Operating margin	24.1%		25.5%		(135)	70	25.4%	(129)	-5%	23.4%
Pretax margin	22.1%		23.2%		(111)	(159)	22.7%	(59)	-3%	23.7%
Net margin	15.6%		16.5%		(90)	53	16.0%	(38)	-2%	15.1%

Source: Company Data, Thomson Reuters, Morgan Stanley Research

Risks to Our Price Target: Margin expansion fails to materialize; Drought persists longer than expected; Increased govt. antibiotic regulations; New pharmacy entrants pressure ZTS margins; Dollar strength relative to foreign currencies causes FX-driven financial shortfalls; SAP implementation.

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Exhibit 2

Zoetis 3Q:13 Revenue Variation (annual)

(\$M)	Actual		MS Estimate		Variation vs. MS Est.		CONS. est.	Variation vs. Cons.		Actual
	3Q:13A	YOY % Chg.	3Q:13E	YOY % Chg.	Absolute	Pct	3Q:13E	Absolute	Pct	3Q:12A
United States (U.S.)	495	10%	479	7%	16	3%	479	16	3%	448
Base revenue	495	10%	479	7%	16	3%				448
Europe/Africa/Middle East (EuAfME)	270	12%	243	1%	27	11%	242	28	12%	241
Total Base revenue	262	9%	243	1%	19	8%				272
Fx impact	8	3%	-	0%	8	*				(31)
Canada/Latin America (CLAR)	171	3%	174	5%	(3)	-1%	168	3	2%	165
Base revenue	180	9%	174	5%	7	4%				188
Fx impact	(9)	-5%	-	0%	(9)	*				(23)
Asia Pacific (APAC)	167	1%	166	1%	1	0%	166	2	1%	165
Base revenue	176	7%	177	8%	(1)	0%				173
Fx impact	(9)	-5%	(11)	-6%	1	N.M.				(8)
Total Revenue	1,103	8%	1,062	4%	41	4%				1,018

Source: Company Data, Streetaccount, Morgan Stanley Research

Exhibit 3

Zoetis 3Q:13 Income Statement Variation (sequential)

(\$M)	Reported	Sequential Growth		Actual
	3Q:13A	Dollar	% Chg.	2Q:13A
Net revenues	1,103	(11)	-1%	1,114
COGS	383	(17)	-4%	400
Gross profit	720	6	1%	714
SG&A	359	20	6%	339
R&D	91	-	0%	91
Amortization of intangibles	4	1	33%	3
Operating income	266	(15)	-5%	281
Other expenses/(income)	22	(7)	-24%	29
Interest expense	29	(3)	-9%	32
Other expense (income)	(7)	(4)	133%	(3)
Pretax income	244	(8)	-3%	252
Taxes	72	(2)	-3%	74
Tax Rate	29.5%	0	0%	29.4%
Income attributable to non-controlling interest	-	-	*	-
Net income (Non-GAAP)	172	(6)	-3%	178

DILUTED EPS, proforma	\$	0.34	(\$0.01)	-3%	\$	0.36
Diluted shares outstanding		500	0	0%		500

Margin Analysis	Reported	Variation	Actual
	3Q:13A	b.p. difference	2Q:13A
COGS	34.7%	-118	35.9%
Gross margin	65.3%	118	64.1%
SG&A	32.5%	212	30.4%
R&D	8.3%	8	8.2%
Operating margin	24.1%	-111	25.2%
Pretax margin	22.1%	-50	22.6%
Net margin	15.6%	-38	16.0%

Source: Company Data, Morgan Stanley Research

Exhibit 4

Zoetis 3Q:13 Revenue Variation (sequential)

(\$M)	Reported	Sequential Growth		Actual
	3Q:13A	Dollar	% Chg.	2Q:13A
United States (U.S.)	495	58	13%	437
Base revenue	495	58	13%	437
Europe/Africa/Middle East (EuAfME)	270	(8)	-3%	278
Total Base revenue	262	(24)	-6%	286
Fx impact	8	16	N.M.	(8)
Canada/Latin America (CLAR)	171	(42)	-20%	213
Base revenue	180	(40)	-15%	220
Fx impact	(9)	(2)	N.M.	(7)
Asia Pacific (APAC)	167	(19)	-10%	186
Base revenue	176	(16)	-5%	192
Fx impact	(9)	(3)	N.M.	(6)
Total Revenue	1,103	(11)	-1%	1,114

Source: Company Data, Morgan Stanley Research

Exhibit 5

2013 Mgmt. Guidance

(\$M)	ZTS	ZTS	Variation (New-Old)	Var % (New/Old)	MS	Variation (ZTS- MS)	Var % (ZTS/ MS)	Cons'	Variation (ZTS- Cons')	Var % (ZTS/ Cons')
<i>Date Provided</i>	<i>8/6/2013</i>	<i>11/5/2013</i>								
Total revenue	\$4,425-\$4,525	\$4,475-\$4,525								
Revenue Midpoint	4,475	4,500	25	1%	4,471	29	1%	4,487	13	0%
COGS (% of sales)	35-36%	35.5%								
Midpoint	35.5%	35.5%	-	0%	35.5%	4 bps	0%	35.5%	5 bps	0%
SG&A	\$1,385-\$1,435	\$1,405-\$1,425								
Midpoint	1,410	1,415	5	0%	1,382	33	2%			
R&D	\$385-\$415	\$380-\$390								
Midpoint	400	385	(15)	-4%	388	(3)	-1%			
Interest expense	~115M	~115M								
Midpoint	115	115	-	0%	117	(2)	-2%			
Other (income)/expenses	~(20M)	~(15M)								
Midpoint	(20)	(15)	5	-25%	(17)	2	-12%			
Non-GAAP tax rate	~29.5%	~29.5%								
Midpoint	29.5%	29.5%	-	0%	29.3%	17 bps	1%			
Adjusted Net Income	~\$680M-\$710M	~\$690M-\$710M								
Midpoint	695	700	5	1%	706	(6)	-1%	\$699	1	0%
Adjusted Diluted EPS	\$1.36-\$1.42	\$1.38-\$1.42								
Midpoint	\$1.39	\$1.40	\$0.01	1%	\$1.41	-\$0.01	-1%	\$1.40	\$0.00	0%

Source: Company Data, Thomson Reuters, Morgan Stanley Research

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(as of October 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	988	34%	400	37%	40%
Equal-weight/Hold	1296	44%	496	46%	38%
Not-Rated/Hold	109	4%	28	3%	26%
Underweight/Sell	541	18%	152	14%	28%
Total	2,934		1076		

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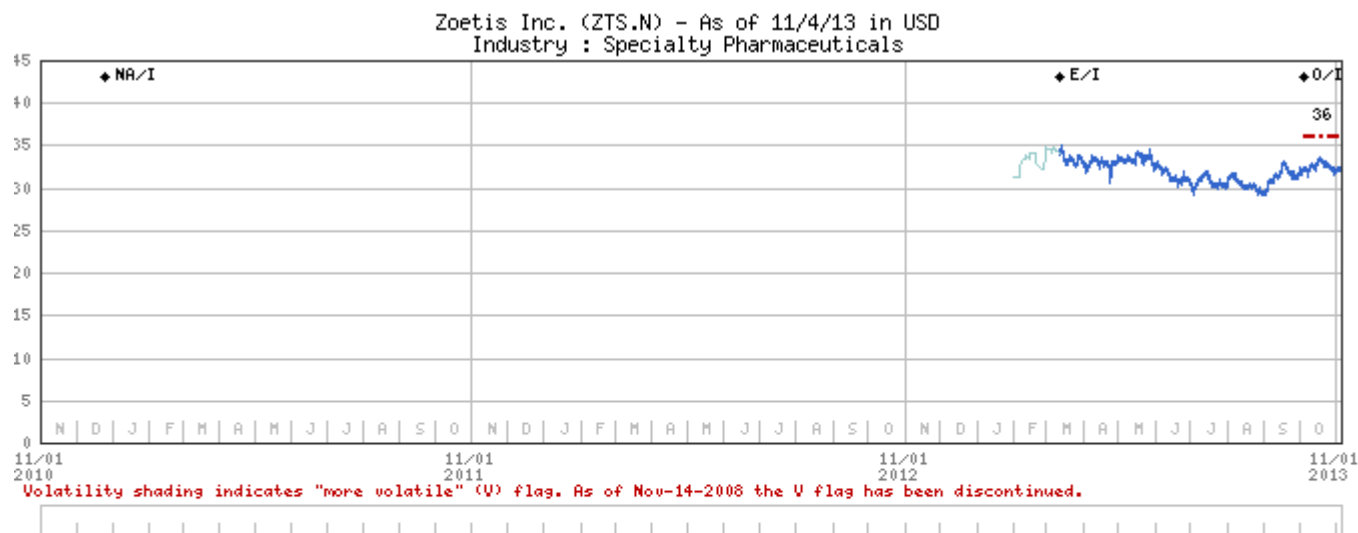
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Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 12/26/10 : NA/I; 3/13/13 : E/I; 10/4/13 : O/I

Price Target History: 3/13/13 : NA; 10/4/13 : 36

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)
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Industry Coverage: Specialty Pharmaceuticals

Company (Ticker)	Rating (as of)	Price* (11/04/2013)
Christopher Caponetti, CFA		
Endo Health Solutions Inc (ENDP.O)	E (07/24/2013)	\$43.64
David Risinger		
Actavis Inc (ACT.N)	O (01/25/2012)	\$157.4
Alkermes Plc. (ALKS.O)	E (10/01/2013)	\$35.52
Allergan Inc. (AGN.N)	E (05/01/2013)	\$90.11
Forest Laboratories Inc. (FRX.N)	E (04/26/2011)	\$46.99
Mylan Inc. (MYL.O)	E (10/14/2013)	\$39.38
Perrigo Co. (PRGO.N)	++	\$143.73
Teva Pharmaceutical Industries Ltd. (TEVA.N)	U (08/05/2013)	\$36.59
Valeant Pharmaceuticals International (VRX.N)	E (09/14/2012)	\$110.33
Zoetis Inc. (ZTS.N)	O (11/05/2013)	\$31.93

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