

Zoetis Inc. (ZTS)

Overweight

Alternate Site Providers: Top Pick for 2013 - Q4 Update

CONCLUSION

ZTS is our top large-cap pick due to its industry-leading position in the stable and mature animal health industry that is growing mid-to-high single digits with no exposure to government reimbursement. While the livestock market, particularly cattle, has experienced headwinds over the past year due to the harsh drought in 2012, we expect the cattle market to improve in late 2013 and into 2014 as herd sizes recover and comps get easier. Additionally, we believe ZTS will continue to rationalize costs as a stand-alone company to drive operating margin expansion. We are removing GTIV as a top pick idea and replacing it with ZTS as we believe ZTS has a lower risk profile, while still offering substantial upside over the long-term. Maintain Overweight rating and \$39 PT.

- **Livestock market could provide a multi-year tailwind.** While the number of cattle in the U.S. is at the lowest levels since the 1950's, we believe the livestock market is slowly recovering and should provide a multi-year growth tailwind as ranchers replenish their herds, which should lead to greater use of medications and vaccines. Comps also get easier in 2H13 and 1H14 as ZTS experienced the greatest impact from the drought in 3Q12. According to the USDA, cattle on feed comps are also easier in the last three months of 2013 as the October, November, and December comps are -3%, -5% and -6%, respectively. This should benefit ZTS as cattle product sales account for approximately 30-35% revenues.
- **Companion animal trends remain favorable.** We believe the companion animal market will continue to grow in the mid-single digits driven by increased pet ownership trends, greater willingness by pet owners to spend more on pets, and continued pet product innovation. ZTS announced FDA approval of APOQUEL, which helps control itching in dogs, in May and the product is expected to launch in 1Q14. Depending on price and uptake from vets, we believe APOQUEL could reach blockbuster status (>\$100 MM) over the next few years. Assuming revenues of \$50-\$150 MM, we estimate APOQUEL could generate an incremental \$0.02-\$0.06 of EPS.
- **Margin expansion story remains intact.** We believe ZTS will be able to drive significant operating margin expansion over the next several years as the company focuses on rationalizing costs as a stand-alone company. We expect margin expansion to be driven by incremental pricing growth, continued focus on manufacturing efficiencies, and disciplined SG&A spending. We estimate every 50 bps of operating margin expansion could add an incremental \$0.03 to annual EPS.

RISKS TO ACHIEVEMENT OF PRICE TARGET

Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

COMPANY DESCRIPTION

Zoetis is the leading global manufacturer of animal health medications and vaccines.

PRICE: US\$32.40

TARGET: US\$39.00

(24.5x FY14E EPS)

Kevin K. Ellich

Sr Research Analyst, Piper Jaffray & Co.
612 303-5666, kevin.k.ellich@pjc.com

Bradley D. Maier

Research Analyst, Piper Jaffray & Co.
612 303-6646, bradley.d.maier@pjc.com

Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	—	US\$4,495.8
FY14E Rev (mil)	—	US\$4,733.0
FY13E EPS	—	US\$1.40
FY14E EPS	—	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.2	
Market Cap. (mil)	US\$16,206.5	
Avg Daily Vol (ooo)	4,664	
Book Value/Share	US\$1.45	
Net Cash Per Share	US\$0.00	
Debt to Total Capital	83%	
Div (ann)	US\$0.26	
Yield	0.80%	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2012A	1,047.0	1,094.0	1,019.0	1,176.0	4,336.0	3.7x	0.30	0.35	0.31	0.11	1.08	30.0x
2013E	1,090.0A	1,114.0A	1,070.4	1,221.4	4,495.8	3.6x	0.36A	0.36A	0.34	0.34	1.40	23.1x
2014E	1,142.2	1,172.0	1,132.1	1,286.7	4,733.0	3.4x	0.39	0.39	0.40	0.41	1.59	20.4x

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Rating, Price Target, and Risks:

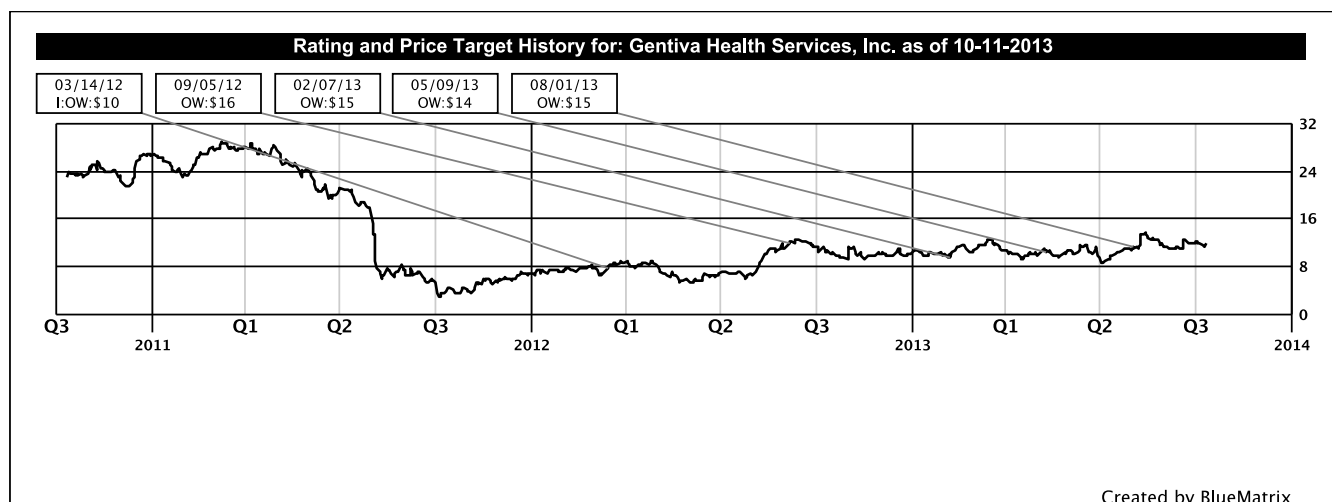
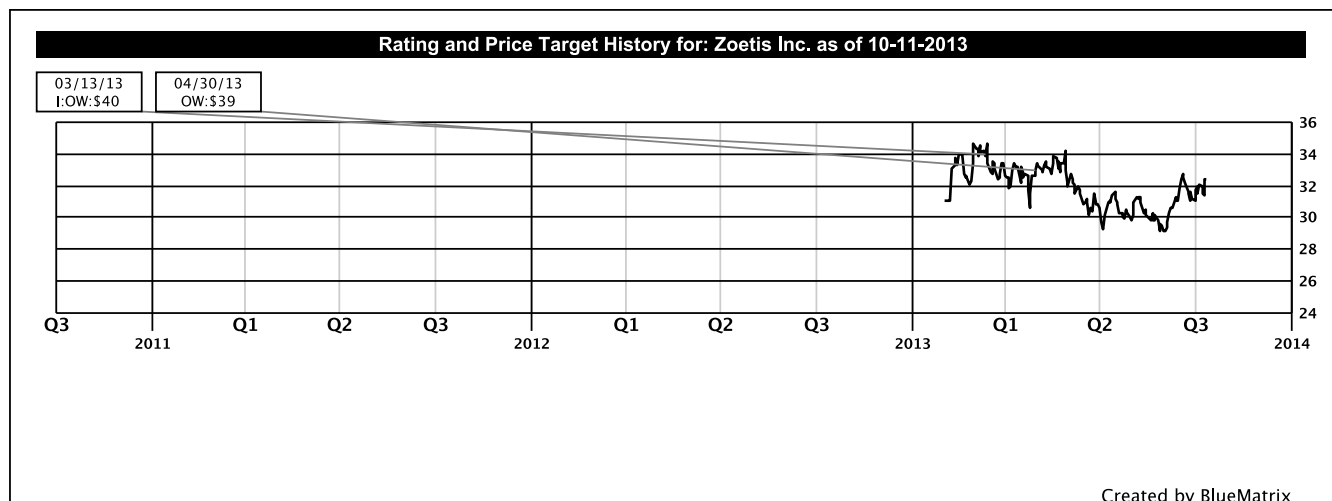
Gentiva Health Services, Inc. (GTIV) is currently rated Overweight with a \$15 price target based on 7.0x FY14E EV/EBITDA. Risks include competition, leverage, regulatory and reimbursement pressures.

Period	FY09	FY10	FY11	1Q12	2Q12	3Q12	4Q12	FY12	1Q13	2Q13	3Q13E	4Q13E	FY13E	1Q14E	2Q14E	3Q14E	4Q14E	FY14E	FY15E
Ending	12/31/09	12/31/10	12/31/11	3/31/12	6/30/12	9/30/12	12/31/12	12/31/12	3/31/13	6/30/13	9/30/13	12/31/13	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	12/31/14	12/31/15
Revenues	\$2,760.0	\$3,582.0	\$4,233.0	\$1,047.0	\$1,094.0	\$1,019.0	\$1,176.0	\$4,336.0	\$1,090.0	\$1,114.0	\$1,070.4	\$1,221.4	\$4,495.8	\$1,142.2	\$1,172.0	\$1,132.1	\$1,286.7	\$4,733.0	\$4,982.9
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	4.1%	1.8%	5.0%	3.9%	3.7%	4.8%	5.2%	5.8%	5.3%	5.3%	5.3%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-7.3%	2.2%	-3.9%	14.1%		-6.5%	2.6%	-3.4%	13.7%		
Cost of sales	1,001.0	1,318.0	1,581.0	388.0	382.0	352.0	\$427.0	1,549.0	398.0	400.0	377.3	431.2	1,606.5	411.2	416.1	387.7	440.7	1,655.7	1,718.2
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	692.0	714.0	693.1	790.3	2,889.3	731.0	756.0	744.3	846.0	3,077.3	3,264.7
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	63.49%	64.09%	64.75%	64.70%	64.27%	64.00%	64.50%	65.75%	65.75%	65.02%	65.52%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	322.0	339.0	326.5	406.1	1,393.6	334.1	355.7	341.3	411.7	1,442.9	1,502.5
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	90.0	91.0	93.7	113.0	387.6	93.1	93.8	93.4	117.1	397.3	403.3
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	3.0	3.0	3.0	13.0	3.5	3.5	3.5	3.5	14.0	14.0
Restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other expenses/(income)	(1.0)	(25.0)	(28.0)	(6.0)	(7.0)	(10.0)	2.0	(21.0)	2.0	(3.0)	(5.0)	(5.0)	(11.0)	(7.0)	(7.0)	(7.0)	(7.0)	(28.0)	(32.0)
Total operating expenses	1,437.0	1,768.0	1,846.0	422.0	438.0	418.0	567.0	1,845.0	418.0	430.0	418.1	517.1	1,783.2	423.7	446.0	431.2	525.3	1,826.2	1,887.8
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	274.0	284.0	274.9	273.2	1,106.1	307.3	310.0	313.1	320.7	1,251.1	1,376.8
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	25.14%	25.49%	25.69%	22.36%	24.60%	26.91%	26.45%	27.66%	24.92%	26.43%	27.63%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	22.0	32.0	30.5	30.5	115.0	31.5	31.5	31.5	31.5	126.0	120.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	252.0	252.0	244.4	242.7	991.1	275.8	278.5	281.6	289.2	1,125.1	1,256.8
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	23.12%	22.62%	22.84%	19.87%	22.05%	24.15%	23.76%	24.88%	22.47%	23.77%	25.22%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	73.0	74.0	72.1	72.8	291.9	81.4	82.2	83.1	85.3	331.9	370.8
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	28.97%	29.37%	29.50%	30.00%	29.45%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%
Net Income	188.0	276.0	506.0	153.0	176.0	153.0	57.0	539.0	179.0	178.0	172.3	169.9	699.2	194.4	196.3	198.5	203.9	793.2	886.1
less: net income attributable to noncont	(1.0)	1.0	3.0	1.0	0.0	(1.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income attributable to Zoetis	189.0	275.0	503.0	152.0	176.0	154.0	57.0	539.0	179.0	178.0	172.3	169.9	699.2	194.4	196.3	198.5	203.9	793.2	886.1
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	16.42%	15.98%	16.10%	13.91%	15.55%	17.02%	16.75%	17.54%	15.84%	16.76%	17.78%
Diluted EPS	\$0.38	\$0.55	\$1.01	\$0.30	\$0.35	\$0.31	\$0.11	\$1.08	\$0.36	\$0.36	\$0.34	\$0.34	\$1.40	\$0.39	\$0.39	\$0.40	\$0.41	\$1.59	\$1.77
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.1	500.2	500.0	500.0	500.1	500.0	500.0	500.0	500.0	500.0	500.0
Dividend			\$0.83	\$0.104	\$0.020	\$0.002	\$0.000	\$0.13	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.26
Dividend yield									0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Payout			82.7%	34.2%	5.7%	0.6%	0.0%	11.7%	0.0%	18.5%	18.9%	19.1%	14.0%	16.7%	16.6%	16.4%	15.9%	16.4%	14.7%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.51%	35.91%	35.25%	35.30%	35.73%	36.00%	35.50%	34.25%	34.25%	34.98%	34.48%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	29.54%	30.43%	30.50%	33.25%	31.00%	29.25%	30.35%	30.15%	32.00%	30.49%	30.15%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.26%	8.17%	8.75%	9.25%	8.62%	8.15%	8.00%	8.25%	9.10%	8.40%	8.09%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	38.35%	38.60%	39.06%	42.34%	39.66%	37.09%	38.05%	38.09%	40.83%	38.58%	37.89%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.21%	3.41%	3.25%	3.25%	3.28%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%
Yr/Yr Growth:																			
Cost of Sales		31.7%	20.0%	5.4%	-10.5%	-9.7%	7.8%	-2.0%	2.6%	4.7%	7.2%	1.0%	3.7%	3.3%	4.0%	2.8%	2.2%	3.1%	3.8%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	5.0%	0.3%	3.9%	5.5%	3.7%	5.6%	5.9%	7.4%	7.1%	6.5%	6.1%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	-2.7%	-3.4%	-1.1%	-7.7%	-4.0%	3.8%	4.9%	4.6%	1.4%	3.5%	4.1%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-3.2%	0.0%	-0.4%	-6.6%	-2.8%	3.4%	3.0%	-0.3%	3.6%	2.5%	1.5%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	15.6%	3.6%	10.4%	50.1%	17.4%	12.2%	9.1%	13.9%	17.4%	13.1%	10.1%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	10.0%	-5.3%	1.0%	39.5%	8.8%	9.5%	10.5%	15.2%	19.2%	13.5%	11.7%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.8%	1.1%	11.9%	198.0%	29.7%	8.6%	10.3%	15.2%	20.0%	13.4%	11.7%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.7%	1.1%	11.9%	198.0%	29.7%	8.7%	10.3%	15.2%	20.0%	13.5%	11.7%

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October 8, 2013

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R: Resuming Coverage
T: Transferring Coverage
D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
N: Neutral
UW: Underweight
NA: Not Available
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	335	56.88	67	20.00
HOLD [N]	228	38.71	13	5.70
SELL [UW]	26	4.41	0	0.00

Note: Distribution of Ratings/IB Services shows the number of companies currently in each rating category from which Piper Jaffray and its affiliates received compensation for investment banking services within the past 12 months. FINRA rules require disclosure of which ratings most closely correspond with "buy," "hold," and "sell" recommendations. Piper Jaffray ratings are not the equivalent of buy, hold or sell, but instead represent recommended relative weightings. Nevertheless, Overweight corresponds most closely with buy, Neutral with hold and Underweight with sell. See Stock Rating definitions below.

Analyst Certification — Kevin K. Ellich, Sr Research Analyst
— Bradley D. Maiers, Research Analyst

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