

Zoetis Inc. (ZTS)

Overweight

Herd Mentality Improves Following Solid 2Q13; Maintain Overweight And \$39 PT

CONCLUSION

We maintain our Overweight rating and \$39 PT following mostly in-line Q2 results and reaffirmed FY13 guidance. We believe in-line Q2 results should alleviate some concerns as management has a good handle on market conditions, which gives us confidence in the company's ability to achieve its guidance. Additionally, we believe cattle product sales should start to improve over the coming months, as younger herds were moved to feedlots earlier this year, driven by lower corn prices and better yields. This should help drive U.S. sales in Q3, which is also an easier y/y comp. While colder weather affected parasiticide sales, the long-term outlook for the companion animal business remains favorable due to increased pet ownership, growing visits to the vet, and owners spending more on pets.

- **Livestock business performing in-line with expectations; cattle expected to improve in 2H13.** Livestock growth of 1% (+3% operationally) was driven by strong growth in swine (+7.0%) and poultry (+6.2), and partially offset by a 4% decline in cattle. Management noted last year's drought is having a lower impact on swine and poultry, while the impact on cattle is in-line with their expectations. Despite some headwinds, we expect a recovery in 2H13 driven by lower corn prices as cattle are expected to be moved to feedlots earlier this year, which will likely result in greater use of medications as the cattle will be younger and lighter. ZTS also experienced the greatest impact from the drought in 3Q12, which makes for an easier y/y comparison.
- **Companion animal business negatively impacted by cold weather, but long-term trends remain favorable.** While we believe the companion animal market remains attractive longer-term, the cold spring weather had a negative impact due to delayed parasiticide sales. Novartis' Sentinel returned to the market during Q2, which had a modest negative impact on sales of Revolution, although ZTS believes it was able to retain some share it gained last year. While the equine market continues to struggle as sales were down 10% due to a slow down in Canada, we remain optimistic on the long-term outlook for the companion animal market given new product introductions, ZTS' ability to increase price, and favorable pet ownership and spending trends.
- **Rationalizing costs a top priority; margin expansion story still intact.** We believe ZTS will continue to focus on rationalizing costs and funding certain one-time cost items including new systems and infrastructure to solidify itself as a stand-alone company. With this in mind, it could take a few quarters before the company starts to deploy capital on strategic acquisitions. That said, we remain confident in ZTS' ability to drive growth through new product launches, e.g. APOQUEL, which recently received a positive opinion in Europe from the CVMP.

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.

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	3.6x	0.30	0.35	0.31	0.11	1.08	28.9x
2013E	1,090.0A	1,114.0A	1,070.4	1,221.4	4,495.8	3.5x	0.36A	0.36A	0.34	0.34	1.40	22.3x
2014E	1,142.2	1,172.0	1,132.1	1,286.7	4,733.0	3.3x	0.39	0.39	0.40	0.41	1.59	19.7x

PRICE: US\$31.25

TARGET: US\$39.00

(24.5x FY14E EPS)

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	US\$4,508.9	US\$4,495.8
FY14E Rev (mil)	US\$4,745.1	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\$15,631.3	
Avg Daily Vol (ooo)	8,222	
Book Value/Share	US\$1.45	
Net Cash Per Share	US\$0.00	
Debt to Total Capital	83%	
Div (ann)	US\$0.26	
Yield	0.83%	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

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2Q13 REVIEW

Total Revenue:

- Total revenues increased 1.8% y/y to \$1,114 MM, which consisted of 4% base growth offset by a 2% FX headwind. Revenues were \$15 MM lower than our estimate and consensus of \$1,129 MM.
- Total livestock revenues increased 1% y/y to \$670 MM, which consisted of 3% base growth offset by a 2% FX headwind.
- Total companion animal revenues increased 3% y/y to \$444 MM, which consisted of 5% base growth offset by a 2% FX headwind.

U.S. Revenue:

- Total U.S. revenues increased 4% y/y to \$437 MM, which was essentially in-line with our estimate of \$438 MM.
- U.S. livestock revenues increased 6% y/y to \$204 MM and were driven by cattle, swine and poultry.
- U.S. companion animal revenues increased 2% y/y to \$233 MM, which were driven by increases in small animal (dogs and cats) products partially offset by the equine market.

EuAfME (Europe/Africa/Middle East) Revenue:

- Total EuAfME revenues decreased 2% y/y to \$278 MM, which consisted of 1% base growth and a 3% FX headwind. EuAfME revenues were \$13.5 MM lower than our estimate of \$291.5 MM.
- EuAfME livestock revenues decreased 5% y/y to \$184 MM, which consisted of -2% base growth and a 3% FX headwind. EuAfME livestock products declined due to lower cattle sales and overall economic weakness in Europe.
- EuAfME companion animal revenues increased 4% y/y to \$94 MM, which consisted of 6% base growth and a 2% FX headwind.

CLAR (Canada/Latin America) Revenue:

- Total CLAR revenues increased 1% y/y to \$213 MM, which consisted of 4% base growth and a 3% FX headwind. CLAR revenues were \$2 MM lower than our estimate of \$215 MM.
- CLAR livestock revenues decreased 1% y/y to \$153 MM, which consisted of 4% base growth and a 5% FX headwind. Growth was primarily driven by poultry and swine, while cattle products declined.
- CLAR companion animal revenues increased 5% y/y to \$60 MM, which consisted of 6% base growth and a 1% FX headwind.

APAC (Asia/Pacific) Revenue:

- Total APAC revenues increased 4% y/y to \$186 MM, which consisted of 7% base growth and a 3% FX headwind. APAC revenues were \$2 MM higher than our estimate of \$184 MM.
- APAC livestock revenues increased 2% y/y to \$129 MM, which consisted of 5% base growth and a 3% FX headwind. Growth was driven by swine products and the continued launch of new vaccines.
- APAC companion animal revenues increased 8% y/y to \$57 MM, which consisted of 13% base growth and a 5% FX headwind.

Livestock Revenue:

- Cattle revenues decreased 4% y/y to \$356 MM, which consisted of a 2% decline in base growth and a 2% FX headwind.
- Swine revenues increased 7% y/y to \$152 MM, which consisted of 9% base growth and a 2% FX headwind.
- Poultry revenues increased 6% y/y to \$137 MM, which consisted of 9% base growth and a 3% FX headwind.
- Other livestock (fish and sheep) revenues increased 9% y/y to \$25 MM, which consisted of 10% base growth and a 1% FX headwind.

Companion Animal Revenue:

- Horse (equine) revenues decreased 10% y/y to \$45 MM, which consisted of a 10% decline in base growth.
- Dogs and cats revenue increased 5% y/y to \$399 MM, which consisted of 7% base growth and a 2% FX headwind.

Segment Earnings:

- U.S. earnings increased 12% y/y to \$254 MM.
- EuAfME earnings increased 3% y/y to \$91 MM, which consisted of 1% base growth and a 2% FX benefit.
- CLAR earnings increased 1% y/y to \$78 MM, which consisted of 7% base growth and a 6% FX headwind.
- APAC earnings increased 13% y/y to \$71 MM, which consisted of 11% base growth and a 2% FX benefit.

Consolidated Earnings:

- Adjusted gross margin decreased 99 basis points y/y and increased 61 basis points sequentially to 64.09% which was 6 basis points lower than our estimate of 64.15%.
- Adjusted operating income increased 3.6% y/y to \$284 MM, which was in-line with our estimate.
- Adjusted operating margin increased 45 basis points y/y to 25.49%, which was 30 basis points higher than our estimate of 25.19%.
- Adjusted EPS of \$0.36 was in-line with our estimate and consensus.

FY13 Guidance Reaffirmed:

- Revenues are expected to be in a range of \$4,425 to \$4,525 MM.
- Adjusted cost of sales as a percentage of revenues is expected to be 35% to 36%.
- Adjusted SG&A expenses are expected to be in a range of \$1,385 to \$1,435 MM.
- Adjusted R&D expenses are expected to be in a range of \$385 to \$415 MM.
- Adjusted interest expense is expected to be approximately \$115 MM.
- Adjusted other (income)/deductions are expected to be approximately \$20 MM (income).
- The effective tax rate is expected to be approximately 29.5%.
- Reported net income is expected to be \$500 to \$530 million, while adjusted net income is expected to be \$680 to \$710 million.
- Reported EPS is expected to be \$1.00-\$1.06. Adj. EPS is expected to be \$1.36-\$1.42.
- Certain significant items and acquisition related costs are expected to be \$200 to \$240 MM.

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%	18.3%	18.9%	19.1%	13.9%	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%	3.25%	3.25%	3.25%	3.24%	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%

Source: Company reports and Piper Jaffray & Co. Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

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IMPORTANT RESEARCH DISCLOSURES



Notes: The boxes on the Rating and Price Target History chart above indicate the date of the Research Note, the rating, and the price target. Each box represents a date on which an analyst made a change to a rating or price target, except for the first box, which may only represent the first Note written during the past three years.

Legend:

I: Initiating Coverage
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]	341	57.31	67	19.65
HOLD [N]	224	37.65	14	6.25
SELL [UW]	30	5.04	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

The views expressed in this report accurately reflect my personal views about the subject company and the subject security. In addition, no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.

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- **Overweight (OW):** Anticipated to outperform relative to the median of the group of stocks covered by the analyst.
- **Neutral (N):** Anticipated to perform in line relative to the median of the group of stocks covered by the analyst.
- **Underweight (UW):** Anticipated to underperform relative to the median of the group of stocks covered by the analyst.

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