Zoetis Inc.

ZTS - BUY - Management Meeting Underscores Our Positive Investment Thesis

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FLASH NOTE

SECTOR: Specialty Pharmaceuticals

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Following our meeting with the CEO, CFO, & IR, we continue to believe the sustainability of ZTS's earnings growth is underappreciated by the Street. ZTS (BUY, $31.81) continues to expand its product indications across species and pursue approvals in new geographies. Based on our discussions with management, we think ZTS is on track to meet or beat our expectations for 2013 and beyond. Furthermore, we believe macro trends (population, limited resources, emerging markets) support the need for ZTS's products. We highlight the key data points that we believe support our positive investment thesis below.

- We think ZTS has better earnings visibility than other companies in our coverage universe. Contrary to the Street, we view the increased SG&A spend in 3Q13 as a positive because it demonstrates that management has the ability to control its costs. ZTS noted that SG&A spend in 1Q13 and 2Q13 was lower because the top line was not as strong so they cut costs. The company spent more in 3Q13 because sales were stronger and they saw an opportunity to reinvest in the company. Also, despite the SG&A increase, ZTS still met its objective of growing sales faster than spend. YTD sales have grown 6%, while spend has increased only 2%.
- Over the next five years, ZTS has a goal of growing sales faster than the market while increasing SG&A and R&D at the rate of inflation (2% to 3%).
- ZTS is not concerned about its high levels of inventory because the company added additional inventory to avoid shortages during its separation from PFE (NC, $32.20). ZTS plans to lower its inventory in 2014.
- We do not think ZTS is interested in a transformational acquisition in the near term, but the company has stated that M&A is a strategic objective going forward. Management seems to be more focused on its separation from PFE and meeting its IPO objectives. ZTS also noted that an acquisition of one the top 10 animal health companies could result in a lot of divestitures (so may not be worthwhile) given ZTS's 20% market share.
- Lowering ZTS's tax rate meaningfully is not a corporate objective for ZTS because manufacturing has to be local for global animal health companies. Therefore, it cannot accumulate large amounts of cash in any one jurisdiction.
- ZTS is not concerned about the movement of animal health products to retailers and the internet, as 95% of its portfolio is prescription drugs. Management also believes that margins will be similar between retailers/internet buyers and veterinarians (usually take a big markup on drugs). The only potential negative is that a move to retailers/internet makes it easier for generics to enter the market, as generic companies don't require a sales force to sell to retailers/internet. We view this as a positive for Perrigo (PRGO, BUY, $153.13)
- With respect to R&D, ZTS is focused on three things: 1) geographic expansion of products; 2) new formulations; and, 3) combinations (for example, putting two vaccines into one shot).
- ZTS thinks that **Apoquel** (controls itch and inflammation in dogs) could be a $100MM product.
- Companion animal drugs have the highest margin, followed by cattle, swine, and then poultry. We think that this is positive for ZTS, as only 36% of 3Q13 sales were attributed to companion animals, which means that this could represent upside to earnings if ZTS grows its companion animal business.

Potential catalysts include: 1) operating margin expansion; 2) new product launches; 3) business development; 4) expansion into adjacent categories; 5) U.S. drought subsides.

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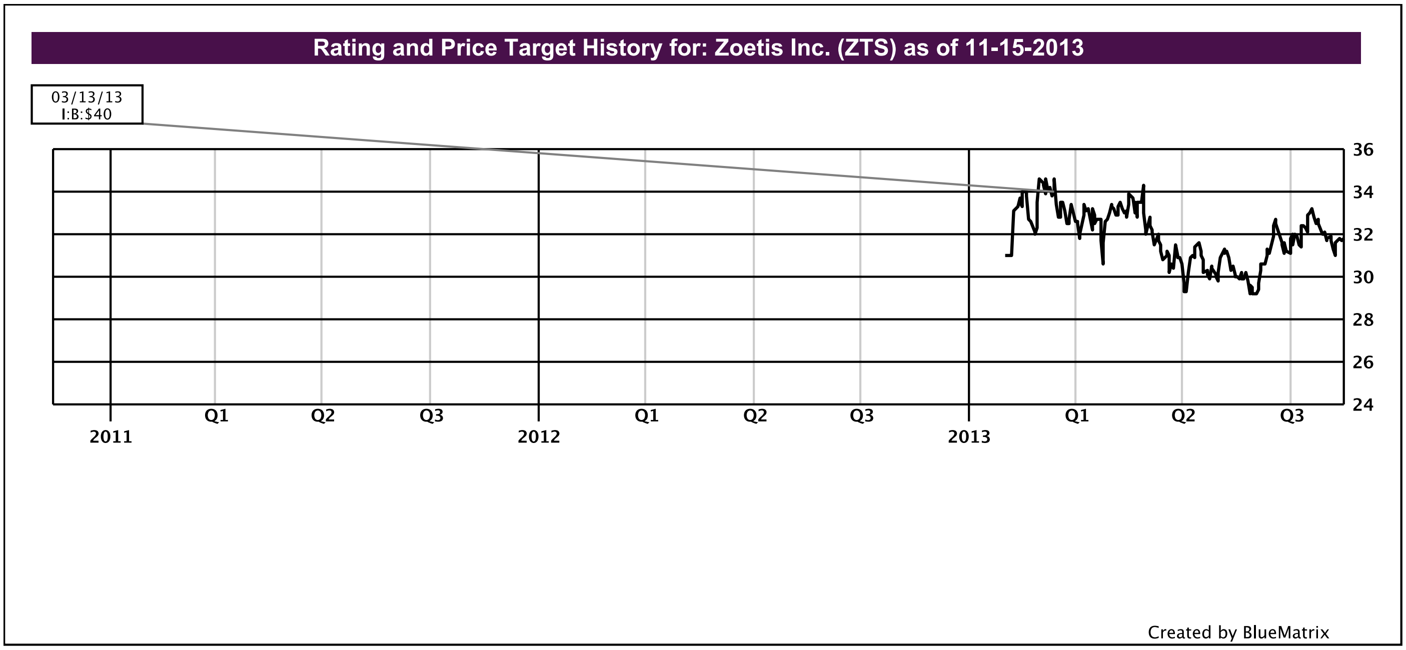

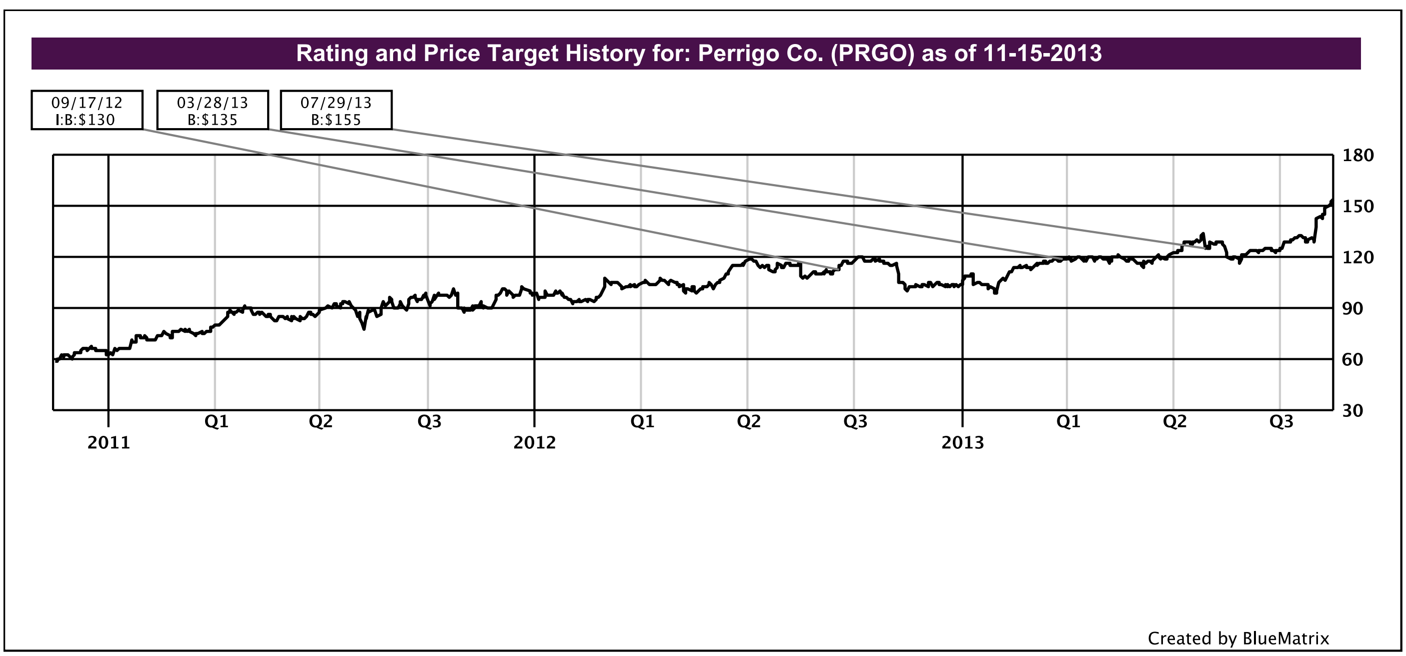

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