

Zoetis Inc ZTS (NYSE) | BBB+

Business Risk	Cash Flow Cushion™	Solvency Score	Distance To Default	Economic Moat™	Industry Group	Sector
Good	Good	Good	Very Good	Wide	Drug Manufacturers	Healthcare

Zoetis' scale advantages and superior portfolio of products give it a wide moat.

Julie Stralow, CFA
julie.stralow@morningstar.com

Committee members voting on rating do not own securities issued by the company.

Credit Analysis as of 20 Dec 2013
Business Analysis as of 20 Dec 2013
Estimates as of 08 Aug 2013

Currency amounts expressed with "\$" are in U.S. dollars (USD) unless otherwise denoted.

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Credit Perspective 20 Aug 2013

We are maintaining our credit rating for Zoetis at BBB+, reflecting its wide moat and manageable debt position. As the leading provider of animal health products, Zoetis possesses many sustainable competitive advantages that should ensure large, steady cash flow to service its debt obligations. We believe Zoetis' wide economic moat stems primarily from intangible assets and scale. In terms of intangible assets, about 20% of its sales come from patent-protected products while strong brand names help protect the rest of its revenue stream. In terms of scale, Zoetis' broad product portfolio helps it support a direct salesforce and bypass distributors, allowing it to control its marketing message and retain more cash flow at the same time. Overall, we believe its continued success in direct sales efforts should prevent competitors from easily supplanting Zoetis' dominant position in the animal health business. Also, development requirements to introduce new animal health products can be time-consuming and costly, which provides another barrier to entry into Zoetis' niche.

As a spin-off from Pfizer (rating: AA), Zoetis is starting off with net debt/EBITDA around 3 times. Although higher than possible in the long run, that leverage level looks easily manageable by the firm, especially since interest rates incurred on its recently issued debt were near historic lows. If profits rise as we expect and Zoetis pays off its 2016 and 2018 maturities rather than refinancing them, the firm could approach a net cash position by early 2018. Also in late June, Pfizer fully unloaded its stake in Zoetis to shareholders. We see Zoetis gaining more independence from its parent company as a positive development for our rating. With that increased independence and the potential for deleveraging in its near future, we see upgrade potential at Zoetis in the next couple years.

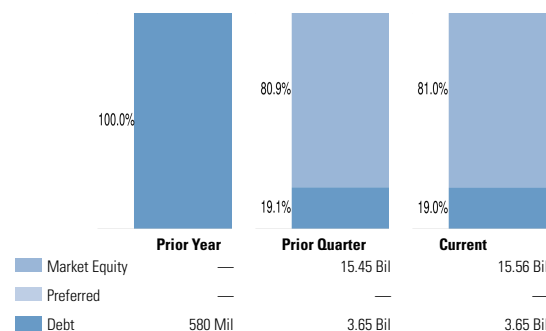
Credit Metrics (USD Mil)

	2011	2012	2013(E)	2014(E)
Cash And Equivalents	79	300	881	1,369
Total Debt	575	3,640	3,640	3,640
Interest Expense	—	—	116	120
EBITDA	837	1,193	1,345	1,422
Debt to Book Capital	0.1	0.8	0.7	0.6
Quick Ratio	1.5	2.0	2.8	3.5
Debt to EBITDA	0.7	3.1	2.7	2.6
EBITDA to Interest Expense	—	—	11.5	11.8

Operating Summary (USD Mil)

	2011	2012	2013(E)	2014(E)
Sales	4,233	4,318	4,518	4,830
% Change	18.2	2.0	4.6	6.9
EBIT	632	988	1,137	1,217
% Net Sales	14.9	22.9	25.2	25.2
Net Income	503	597	723	775
% Net Sales	11.9	13.8	16.0	16.0
Free Cash Flow	-8	335	794	748
% Net Sales	-0.2	7.8	17.6	15.5

Capital Structure



Source: Morningstar

Issuer Profile

Zoetis sells anti-infectives, vaccines, parasiticides, and other health products for animals. The firm earns the majority of its revenue from production animals (cattle, pigs, poultry, etc.) but also sells companion animal (dogs, horses, cats) products. The firm has the largest market share in the industry and was previously Pfizer's animal health unit.

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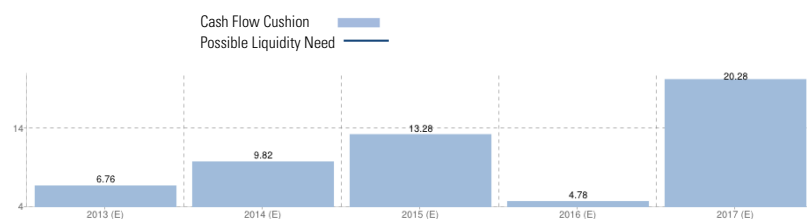
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Credit Analysis

Five Year Adjusted Cash Flow Forecast (USD Mil)

	2013(E)	2014(E)	2015(E)	2016(E)	2017(E)
Cash and Equivalents (beginning of period)	300	881	1,369	1,896	2,064
Adjusted Available Cash Flow	707	617	658	711	763
Total Cash Available before Debt Service	1,007	1,498	2,027	2,608	2,827
Principal Payments	—	—	—	-400	—
Interest Payments	-116	-120	-120	-114	-107
Other Cash Obligations and Commitments	-33	-33	-33	-33	-33
Total Cash Obligations and Commitments	-149	-153	-153	-546	-139

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	300	26.3
Sum of 5-Year Adjusted Free Cash Flow	3,457	303.3
Sum of Cash and 5-Year Cash Generation	3,757	329.6
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	3,757	329.6
Sum of 5-Year Cash Commitments	-1,140	—

Credit Rating Pillars—Peer Group Comparison

	ZTS	Sector	Universe
Business Risk	4	4.9	5.1
Cash Flow Cushion	4	5.1	6.1
Solvency Score	4	4.4	5.0
Distance to Default	2	3.2	3.9
Credit Rating	BBB+	A-	BBB+

Source: Morningstar Estimates

Note: Scoring is on a scale 1-10, 1 being Best, 10 being Worst

Financial Health & Capital Structure

Prior to being split off from Pfizer, Zoetis took on \$3.65 billion in debt. Zoetis produces reliable cash flow with minimal volatility, so at just 2.5 times our 2014 EBITDA estimate, we do not anticipate the firm having any trouble meeting its obligations.

Enterprise Risk

The FDA recently issued guidelines for the use of antibiotics in animals. The new guidelines call for voluntary monitoring of use in animals, so we do not expect it to have a significant impact on Zoetis sales; however, there is risk that the FDA could eventually issue more restrictive guidelines.

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Business Analysis

Investment Thesis

Zoetis is the clear leader in the global animal health industry, and we believe it possesses the widest moat of all the players. While the industry as a whole possesses many characteristics that are conducive to moats, Zoetis's leading revenue and global infrastructure gives it a cost advantage over competitors.

The animal health industry has been largely ignored because animal health businesses are buried within larger human health companies, but the industry has many attractive characteristics, including cash-pay buyers, a fragmented customer base, and minimal generic competition. Due to the fragmented and cash-pay customer base, animal drugmakers hold significant pricing power. On the human health side, firms are traditionally at the mercy of payers. Government payers or large managed-care organizations have the power to force generic utilization, squash price increases, and even in extreme cases force price cuts onto drug manufacturers. However, animal health products are purchased by a fragmented group of meat producers, veterinarians, and pet owners, allowing very little bargaining power over the highly concentrated animal health firms.

This industry also benefits from favorable growth tailwinds that should allow Zoetis to grow revenue at a high single digit growth rate over the next five years. On the production animal side, rising standards of living in emerging markets should lead to wider adoption of meat-heavy diets, driving greater demand for livestock products. On the companion side, Zoetis will benefit from pet owners' increasingly viewing pets as members of the family, which drastically increases their willingness to pay for expensive treatments. Zoetis is likely to grow at a rate relatively close to the industry, but the firm should be able to maintain above average margins due to its scale. Especially in the emerging markets, Zoetis' scale allows it to utilize its own

salesforce, while smaller competitors are often forced to rely on more expensive distributors.

Economic Moat

Zoetis earns a wide economic moat as a result of its intangible assets and scale. Although patents are not essential for maintaining a product in the animal health industry, 20% of the firm's revenue comes from products protected by patents that allow Zoetis to charge a premium price and insulate it from competition. The firm's strong brand name gives Zoetis another advantage over competitors. When customers are using drugs on potentially millions of dollars' worth of livestock, or a pet that they love like a family member, they will be willing to pay a premium to buy from a firm they trust.

Scale also provides Zoetis with a key advantage. Because of the highly fragmented customer base, the sales force, distribution, and relationships are extremely important. Launching a new product is not as simple as getting one large payer (managed-care organization, Medicare, or government) on board; the company needs to individually deal with veterinarians and meat producers. Zoetis' broad portfolio can support its own sales force, allowing the firm to bypass distributors.

Barriers to entry are significant in both capital and time. Although not nearly as expensive or as time-consuming as in human health, it is still very challenging to bring a new animal health product to market. Given the small market size and relatively modest sales potential of products, the reward often will not justify a new competitor pursuing clinical trials to bring a product to market.

One of the best examples of the strength of Zoetis' moat is its pain medication for dogs, Rimadyl. The product lost patent exclusivity in 2001, but sales are currently 35% higher than they were in 2001. Vets' relationship and trust

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Business Analysis

in Zoetis have allowed Rimadyl to maintain and increase sales despite generic competition.

Moat Trend

We believe Zoetis has a stable moat trend. The company competes in a very mature industry that is not experiencing any significant changes. With the heavy concentration among top firms and few revolutionary products in development, we do not expect the industry to face any material changes to its competitive landscape.

Stewardship

With limited results by which to judge current management, we default to a standard stewardship rating. Juan Ramon Alaix has been president of the Pfizer Animal Health business since 2006 and will be CEO of Zoetis. Under his leadership, Pfizer's animal health unit successfully integrated Fort Dodge Animal Health and Alpharma. Before that, he was regional president of Central/Southern Europe for Pfizer's pharmaceutical division. We believe his seven years running the company give him significant operational experience, but he will be faced with many new challenges running an independent public company rather than a subsidiary. Zoetis' CFO will be Richard Passov, who has spent more than 15 years in Pfizer's finance department, most recently as senior vice president and treasurer.

Acquisition opportunities are limited in the animal health industry, so we expect the majority of Zoetis' free cash flow to be returned to shareholders. The firm plans to initiate a quarterly dividend of \$0.065 per share, which should result in about a 1% dividend yield. Debt repayment will require only a small amount of free cash flow, so Zoetis should have the capacity to increase its dividend or initiate a stock repurchase program.

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Recent Notes from our Credit and Equity Analysts

Zoetis Posts In-Line 3Q Results 05 Nov 2013

Zoetis reported third-quarter results that were in line with our expectations. The firm's top line grew 8% due to high-single-digit growth across all major geographic regions, and adjusted EPS grew 10%. Management slightly raised its full-year adjusted EPS guidance, from \$1.36-\$1.42 to \$1.38-\$1.42, but we do not plan to change our fair value estimate or wide moat rating.

Revenue grew 9% operationally over the prior year. Surprisingly, the developed markets posted the strongest growth this quarter. Europe had been Zoetis' slowest-growing segment for most of the year but posted 9% constant currency growth this quarter. The U.S. posted 10% growth, but results were slightly inflated because of last year's drought causing weak prior-year comparisons. Latin America and the Asia Pacific geographic segments posted 9% and 7% growth, respectively. Long term, we still expect the emerging markets to be the key growth drivers for the company and increase at rates above the developed markets.

Operating margin for the quarter was 24.8%, a slight improvement from 24.4% in the prior year. The firm's improvement was largely due to a reduction in research and development spending. We expect the firm to continue to benefit from leveraging its selling, general, and administrative expenses as it grows, but it will be partially offset by the lower-margin emerging markets making up a larger portion of revenue. Zoetis plans to launch Actogain, a beta-agonist for cattle, in late 2014, which would compete in the market that Merck's Zilmax was just removed from, but given the firm's diversification we do not anticipate it having a material impact on the company's growth rate.

Zoetis 2Q Results Meet Expectations, Shares Remain Overvalued 06 Aug 2013

Zoetis reported second-quarter results that were in line with our expectations. Management reiterated its full-year guidance, and we do not plan any changes to our fair value estimate. We continue to award Zoetis a wide economic moat, but we believe the shares are overvalued at approximately 22 times 2013 estimated EPS. We believe the market is pricing in too-optimistic expectations that Zoetis as an independent company will be able to significantly cut costs and increase earnings well in excess of revenue growth.

Revenue rose 5% on a constant currency basis, which is at the low end of management's expectation of a long-term market growth rate of 5%-7%. Weakness in Europe continues to weigh on the firm, with the European livestock business reporting a 2% decline. The U.S. companion business also slowed significantly this quarter, reporting a 2% growth rate versus the 13% growth rate it reported in the first quarter. The change was partially due to a significant drop in sales of the firm's Revolution product as a result of renewed competition. Novartis had pulled its Sentinel product line from the market in the first quarter, leading to a significant increase in sales of Pfizer's Revolution, but in the second quarter Sentinel returned to the market with a 50% price cut. Novartis has stated the new lower price is a permanent price, rather than a temporary promotion, so we expect Revolution sales to remain under pressure.

Zoetis' adjusted earnings per share of \$0.36 was essentially flat with the \$0.35 reported in the same quarter last year. A lower SG&A ratio and tax rate helped increase earnings, but were offset by a slightly lower gross-margin and higher interest expense related to the firm's recently issued debt. Operating margin for the quarter was 25.5% versus 25.0% in the prior quarter. We expect Zoetis to continue seeing

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operating margin improvement in the coming years, although the firm already posts margins well above the industry norm and we think it is unlikely to reach Sanofi animal health's 29%-30% operating margin given that Zoetis lacks a blockbuster consumer product like Sanofi's Frontline.

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Morningstar Analyst Forecasts

Income Statement (USD Mil)

Fiscal Year Ends in December

	2010	2011	2012	Forecast	
				2013	2014
Revenue	3,582	4,233	4,318	4,518	4,830
Cost of Goods Sold	1,444	1,652	1,554	1,604	1,715
Gross Profit	2,138	2,581	2,763	2,914	3,115
Selling, General & Administrative Expenses	1,382	1,453	1,295	1,396	1,473
Research & Development	411	427	432	384	425
Other Operating Expense (Income)	—	—	—	-3	—
Depreciation & Amortization (if reported separately)	58	69	48	—	—
Operating Income (ex charges)	287	632	988	1,137	1,217
Restructuring & Other Cash Charges	109	238	55	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	178	394	933	1,137	1,217
Interest Expense	—	—	—	116	120
Interest Income	—	—	14	—	—
Pre-Tax Income	178	394	947	1,020	1,097
Income Tax Expense	67	146	350	297	323
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	-1	-3	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	110	245	597	723	775
Weighted Average Diluted Shares Outstanding	505	505	500	500	500
Diluted Earnings Per Share	0.22	0.49	1.19	1.45	1.55
Adjusted Net Income	275	503	597	723	775
Diluted Earnings Per Share (Adjusted)	0.55	1.00	1.19	1.45	1.55
Dividends Per Common Share	0.41	0.82	0.83	0.26	0.35
EBITDA	363	599	1,138	1,345	1,422
Adjusted EBITDA	472	837	1,193	1,345	1,422

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Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December

	2010	2011	2012	Forecast	
				2013	2014
Cash and Equivalents	63	79	300	881	1,369
Investments	—	—	—	—	—
Accounts Receivable	773	871	848	866	926
Inventory	995	1,063	1,136	1,169	1,250
Deferred Tax Assets (Current)	97	96	68	68	68
Other Short Term Assets	188	202	225	225	225
Current Assets	2,116	2,311	2,577	3,209	3,838
Net Property Plant, and Equipment	1,148	1,243	1,229	1,196	1,181
Goodwill	934	989	981	981	981
Other Intangibles	924	928	877	877	877
Deferred Tax Assets (Long-Term)	70	143	100	100	100
Other Long-Term Operating Assets	92	97	73	73	73
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	5,284	5,711	5,837	6,436	7,050
Accounts Payable	206	214	192	198	212
Short-Term Debt	38	—	—	—	—
Deferred Tax Liabilities (Current)	24	18	—	—	—
Other Short-Term Liabilities	540	611	527	527	527
Current Liabilities	808	843	719	725	739
Long-Term Debt	673	575	3,640	3,640	3,640
Deferred Tax Liabilities (Long-Term)	218	311	254	254	254
Other Long-Term Operating Liabilities	141	124	165	165	165
Long-Term Non-Operating Liabilities	100	122	—	—	—
Total Liabilities	1,940	1,975	4,778	4,784	4,798
Preferred Stock	—	—	—	—	—
Common Stock	3,418	3,785	5	5	5
Additional Paid-in Capital	—	—	1,234	1,234	1,234
Retained Earnings (Deficit)	-74	-65	-195	398	998
(Treasury Stock)	—	—	—	—	—
Other Equity	—	16	—	—	—
Shareholder's Equity	3,344	3,736	1,044	1,637	2,237
Minority Interest	—	—	15	15	15
Total Equity	3,344	3,736	1,059	1,652	2,252

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Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in December

	2010	2011	2012	Forecast	
				2013	2014
Net Income	111	248	248	723	775
Depreciation	185	205	205	208	205
Amortization	—	—	—	—	—
Stock-Based Compensation	16	19	19	20	22
Impairment of Goodwill	16	78	78	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-68	65	65	—	—
Other Non-Cash Adjustments	-106	-1	-1	—	—
(Increase) Decrease in Accounts Receivable	30	-85	-85	-18	-60
(Increase) Decrease in Inventory	117	40	40	-33	-81
Change in Other Short-Term Assets	-19	11	11	—	—
Increase (Decrease) in Accounts Payable	25	-16	-16	6	14
Change in Other Short-Term Liabilities	-53	-67	-67	—	—
Cash From Operations	254	497	497	907	874
(Capital Expenditures)	-124	-135	-135	-175	-190
Net (Acquisitions), Asset Sales, and Disposals	-81	-345	-345	—	—
Net Sales (Purchases) of Investments	203	34	34	—	—
Other Investing Cash Flows	-7	-3	-3	—	—
Cash From Investing	-9	-449	-449	-175	-190
Common Stock Issuance (or Repurchase)	—	—	—	—	—
Common Stock (Dividends)	-207	-416	-416	-130	-175
Short-Term Debt Issuance (or Retirement)	—	—	—	—	—
Long-Term Debt Issuance (or Retirement)	—	-143	-143	—	—
Other Financing Cash Flows	-70	529	529	-20	-22
Cash From Financing	-277	-30	-30	-150	-197
Exchange Rates, Discontinued Ops, etc. (net)	-4	-2	-2	—	—
Net Change in Cash	-36	16	16	581	488

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Merck & Co Inc MRK USA	11,743 USD	65.2	74.9	75.0	37.0	36.2	36.8	22.3	21.4	22.6	24.8	23.8	23.3	17.1	17.1	20.2
Sanofi SNY USA	8,101 EUR	69.1	67.6	68.5	24.1	30.8	32.8	21.3	18.8	22.3	22.5	19.6	21.3	18.2	14.2	18.9
Eli Lilly and Company LLY USA	3,784 USD	78.8	79.0	75.0	32.0	27.8	22.8	25.5	24.6	19.6	16.7	19.8	15.4	19.5	17.4	16.5
Average		71.0	73.8	72.8	31.0	31.6	30.8	23.0	21.6	21.5	21.3	21.1	20.0	18.3	16.2	18.5
Zoetis Inc ZTS US	597 USD	64.0	64.5	64.5	27.6	29.8	29.5	22.9	25.2	25.2	13.8	16.0	16.0	8.4	16.2	14.2

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Merck & Co Inc MRK USA	20,569 USD	38.8	46.3	44.5	28.0	31.7	30.8	24.5	20.1	18.6	1.2	1.4	1.3	2.0	2.1	2.1
Sanofi SNY USA	14,531 EUR	25.3	27.3	25.5	20.2	21.4	20.3	15.7	16.9	21.0	1.7	1.5	1.3	1.8	1.7	1.7
Eli Lilly and Company LLY USA	5,531 USD	37.5	40.9	39.5	27.3	29.0	28.3	40.6	42.2	28.1	0.8	1.0	1.4	2.3	2.3	2.2
Average		33.9	38.2	36.5	25.2	27.4	26.5	26.9	26.4	22.6	1.2	1.3	1.3	2.0	2.0	2.0
Zoetis Inc ZTS US	3,640 USD	348.7	222.3	162.7	77.7	69.0	61.9	—	11.5	11.8	3.1	2.7	2.6	5.6	3.9	3.2

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
		2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)	2012	2013(E)	2014(E)
Merck & Co Inc MRK USA	142,561 USD	7.62	8.43	8.15	2.30	2.78	2.65	1.94	2.40	2.28	5.43	12.23	11.57	82.9	108.1	95.1
Sanofi SNY USA	137,286 USD	4.97	7.29	8.81	1.65	1.98	2.15	1.18	1.50	1.67	1.72	2.53	3.05	63.9	90.9	73.0
Eli Lilly and Company LLY USA	56,490 USD	5.09	5.55	5.90	1.55	1.48	1.45	1.24	1.17	1.14	477.67	5.48	5.49	53.6	45.0	70.1
Average		5.89	7.09	7.62	1.83	2.08	2.08	1.45	1.69	1.70	161.61	6.75	6.70	66.8	81.3	79.4
Zoetis Inc ZTS US	16,155 USD	0.60	1.76	2.74	3.58	4.43	5.19	2.00	2.81	3.50	—	—	—	69.7	18.0	22.6

Morningstar's Approach to Rating Corporate Credit

- Offers a proprietary measure of the credit quality of companies on our coverage list.
- Encapsulates our in-depth modeling and quantitative work in one letter grade.
- Allows investors to rank companies by each of the four underlying components of our credit ratings, including both analyst-driven and quantitative measures.
- Provides access to all the underlying forecasts that go into the rating, available through our institutional service.

Purpose

The Morningstar Corporate Credit Rating measures the ability of a firm to satisfy its debt and debt-like obligations. The higher the rating, the less likely we think the company is to default on these obligations.

The Morningstar Corporate Credit Rating builds on the modeling expertise of our securities research team. For each company, we publish:

- Five years of detailed pro-forma financial statements
- Annual estimates of free cash flow
- Annual forecasts of return on invested capital
- Scenario analyses, including upside and downside cases
- Forecasts of leverage, coverage, and liquidity ratios for five years
- Estimates of off balance sheet liabilities

These forecasts are key inputs into the Morningstar Corporate Credit Rating and are available to subscribers at select.morningstar.com.

Methodology

We feel it's important to perform credit analysis through different lenses—qualitative and quantitative, as well as fundamental and market-driven. We therefore evaluate each company in four broad categories.

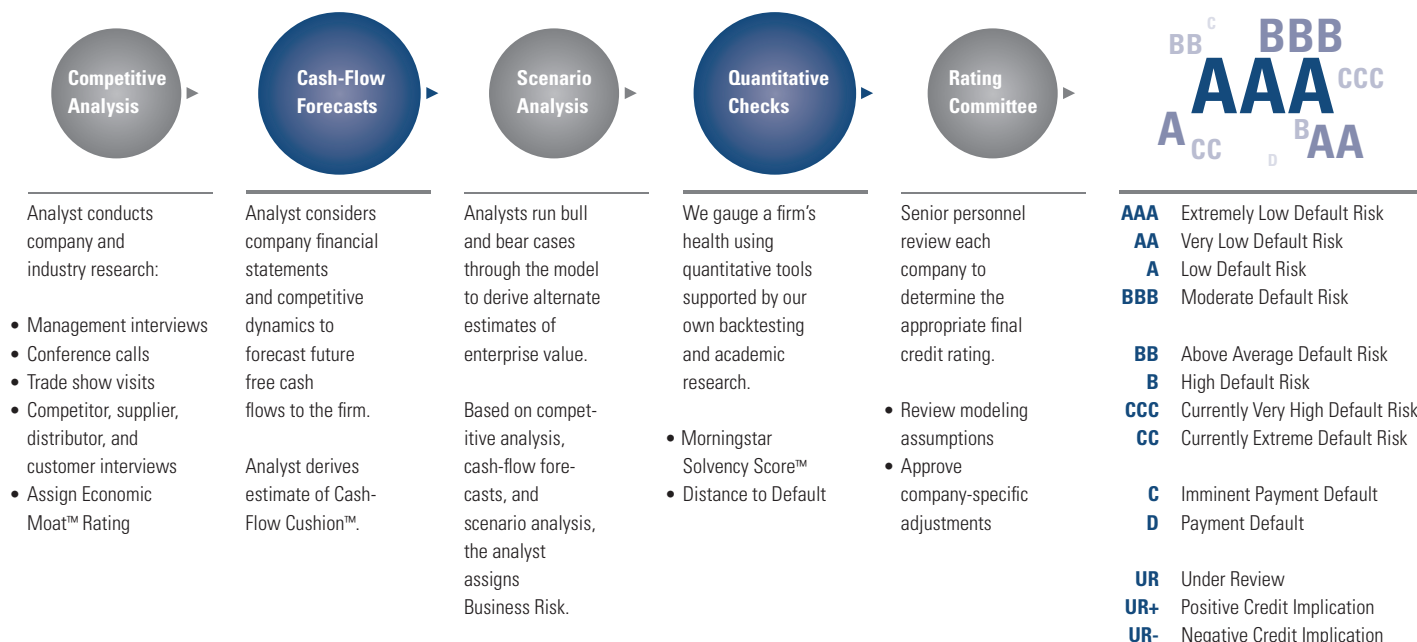
Business Risk

Business Risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. Key components of the Business Risk rating include the Morningstar Economic Moat™ Rating and the Morningstar Uncertainty Rating.

Cash Flow Cushion™

Morningstar's proprietary Cash Flow Cushion™ ratio is a fundamental indicator of a firm's future financial health. The measure reveals how many times a company's internal cash generation plus total excess liquid cash will cover its debt-like contractual commitments over the next five years. The Cash Flow Cushion acts as a predictor of financial distress, bringing to light potential refinancing, operational, and liquidity risks inherent to the firm.

Morningstar Research Methodology for Determining Corporate Credit Ratings



Morningstar's Approach to Rating Corporate Credit

The advantage of the Cash Flow Cushion ratio relative to other fundamental indicators of credit health is that the measure focuses on the future cash-generating performance of the firm derived from Morningstar's proprietary discounted cash flow model. By making standardized adjustments for certain expenses to reflect their debt-like characteristics, we can compare future projected free cash flows with debt-like cash commitments coming due in any particular year. The forward-looking nature of this metric allows us to anticipate changes in a firm's financial health and pinpoint periods where cash shortfalls are likely to occur.

Morningstar Solvency Score™

The Morningstar Solvency Score™ is a quantitative score derived from both historical and forecasted financial ratios. It includes ratios that focus on liquidity (a company's ability to meet short term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how does the company finance its operations), and interest coverage (how much of profit is used up by interest payments).

Distance to Default

Morningstar's quantitative Distance to Default measure ranks companies on the likelihood that they will tumble into financial distress. The measure is a linear model of the percentile of a firm's leverage (ratio of Enterprise Value to Market Value), the percentile of a firm's equity volatility relative to the rest of the universe and the interaction of these two percentiles. This is a proxy methodology for the common definition of Distance to Default which relies on option-based pricing models. The proxy has the benefit of increased breadth of coverage, greater simplicity of calculation, and more predictive power.

For each of these four categories, we assign a score, which we then translate into a descriptive rating along the scale of Very Good / Good / Fair / Poor / Very Poor.

Overall Credit Rating

The four component ratings roll up into a single preliminary credit rating. To determine the final credit rating, a credit committee of at least five senior research personnel reviews each preliminary rating.

We review credit ratings on a regular basis and as events warrant. Any change in rating must be approved by the Credit Rating Committee.

Investor Access

Morningstar Corporate Credit Ratings are available on Morningstar.com. Our credit research, including detailed cash-flow models that contain all of the components of the Morningstar Corporate Credit Rating, is available to subscribers at select.morningstar.com.