

Zoetis Inc. (ZTS)

Overweight

Solid Q1 Results Despite A Few Concerns; Maintain Overweight Rating, PT To \$39

CONCLUSION

We remain positive on ZTS following solid Q1 results, highlighted by strong companion animal growth in the U.S. and EuAfME. Livestock growth was driven by swine and poultry, while cattle growth declined 2%. We believe some concerns were alleviated as FY13 guidance was mostly in line with the Street. Revenues were driven by 7% base growth in the U.S., which was driven by 13% growth in the companion animal business; U.S. livestock growth was only 2% due to the impact from the drought. We maintain our Overweight on ZTS as we believe the company will be able to drive significant margin expansion over the next few years as costs are rationalized as a stand-alone entity, and tweak our PT to \$39 (from \$40) based on 24.5x (unchanged) our FY14E EPS.

- **Management focused on revenue growth and rationalizing costs.** We remain encouraged with ZTS' operating margin expansion opportunity as costs continue to be rationalized as a stand-alone company. Q1 operating margins increased 250 bps y/y to 25.14%, which was 41 bps higher than our estimate. The EuAfME region saw strong leverage as base revs increased 4%, while earnings grew 16% operationally due to strong gross margins and efficient expense management. We believe operating margin expansion will be driven by incremental price increases, continued focus on efficiencies in manufacturing, and disciplined SG&A spending.
- **Mostly in-line FY13 guidance could be conservative.** ZTS issued FY13 revenue guidance of \$4,425 to \$4,525 MM and adjusted EPS guidance of \$1.36 to \$1.42, which were mostly in-line with expectations. While there are still some uncertainties and moving parts, we believe FY13 guidance could be conservative if some of the headwinds ZTS faces moderate throughout the year. ZTS has included a few issues into guidance, including a competitor's product coming back to market in Q2, the negative impact from extended cold weather in Europe, and headwinds from smaller cattle herds due to last year's drought. While cattle inventory is at its lowest level ever, growth in poultry and swine could help mitigate some of the drought impact. Additional guidance details are on page 3.
- **Strong U.S. companion animal growth is encouraging.** While there was a one-time benefit in Q1 due to a competitor manufacturing issue, U.S. companion animal growth was encouraging and should remain relatively strong throughout 2013. Management indicated vet visits and pet owner spending is up this year, which is a positive for future sales growth. Aside from strong growth in the U.S., companion animal sales in EuAfME increased 6% operationally despite the delayed parasiticide season due to the cold weather in Europe.

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\$33.02
TARGET: US\$39.00
(24.5x FY14E EPS)

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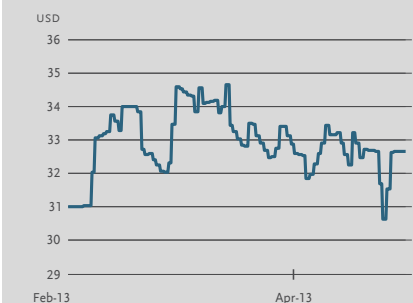
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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	US\$40.00	US\$39.00
FY13E Rev (mil)	US\$4,504.3	US\$4,508.9
FY14E Rev (mil)	US\$4,762.1	US\$4,745.1
FY13E EPS	US\$1.42	US\$1.40
FY14E EPS	US\$1.62	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.1	
Market Cap. (mil)	US\$16,513.3	
Book Value/Share	US\$8.08	
Net Cash Per Share	US\$0.53	
Debt to Total Capital	75%	
Div (ann)	US\$0.26	
Yield	0.79%	
Fiscal Year End	Dec	

Note: price reflects close on 4/30/13.

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	3.8x	0.30	0.35	0.31	0.11	1.08	30.6x
2013E	1,090.0A	1,128.9	1,061.2	1,228.7	4,508.9	3.7x	0.36A	0.36	0.34	0.34	1.40	23.6x
2014E	1,138.7	1,189.7	1,122.4	1,294.3	4,745.1	3.5x	0.39	0.40	0.39	0.41	1.59	20.8x

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1Q13 REVIEW

Total Revenue:

- Total revenues increased 4.1% y/y to \$1,090 MM, which consisted of 5% base growth and was offset by a 1% FX headwind. Revenues were \$16.8 MM higher than our estimate of \$1,073 MM and \$11 MM higher than consensus of \$1,079 MM.
- Total livestock revenues increased 2% y/y to \$706 MM, which consisted of 3% base growth and was offset by a 1% FX headwind.
- Total companion animal revenues increased 8% y/y to \$384 MM.

U.S. Revenue:

- Total U.S. revenues increased 7% y/y to \$454 MM, which was \$12 MM higher than our estimate of \$442 MM.
- U.S. livestock revenues increased 2% y/y to \$245 MM and were lower due to the drought and smaller cattle herds.
- U.S. companion animal revenues increased 13% y/y to \$209 MM, which included a benefit due to a competitor supply issue.

EuAfME Revenue:

- Total EuAfME revenues increased 5% y/y to \$290 MM, which consisted of 4% base growth and a 1% FX benefit. EuAfME revenues were \$15 MM higher than our estimate of \$275 MM.
- EuAfME livestock revenues increased 4% y/y to \$195 MM, which consisted of 3% base growth and a 1% FX benefit. EuAfME had strong growth in swine and poultry.
- EuAfME companion animal revenues increased 8% y/y to \$95 MM, which consisted of 6% base growth and a 2% FX benefit.

CLAR Revenue:

- Total CLAR revenues decreased 1% y/y to \$171 MM, which consisted of 4% base growth and a 5% FX headwind. CLAR revenues were \$2.5 MM lower than our estimate of \$173.5 MM.
- CLAR livestock revenues increased 1% y/y to \$139 MM, which consisted of 6% base growth and a 5% FX headwind. Brazil and Canada had strong growth in products for swine, cattle, and poultry.
- CLAR companion animal revenues decreased 9% y/y to \$32 MM, which consisted of a 5% decline in base growth and a 4% FX headwind.

APAC Revenue:

- Total APAC revenues increased 1% y/y to \$175 MM, which consisted of 2% base growth and a 1% FX headwind. APAC revenues were \$7.7 MM lower than our estimate of \$182.7 MM.
- APAC livestock revenues increased 1% y/y to \$127 MM, which consisted of 3% base growth and a 2% FX headwind. Livestock products for swine had strong growth in Australia, New Zealand and Southeast Asia.
- APAC companion animal revenues were flat y/y at \$48 MM, which consisted of 2% base growth and a 2% FX headwind.

Livestock Revenue:

- Cattle revenues decreased 3% y/y to \$390 MM, which consisted of a 2% decline in base growth and a 1% FX headwind.
- Swine revenues increased 10% y/y to \$158 MM, which consisted of 11% base growth and a 1% FX headwind.
- Poultry revenues increased 10% y/y to \$133 MM, which consisted of 12% base growth and a 2% FX headwind.
- Other livestock (fish and sheep) revenues decreased 7% y/y to \$25 MM, which consisted of a 3% decline in base growth and a 4% FX headwind.

Companion Animal Revenue:

- Horse revenues decreased 7% y/y to \$42 MM, which consisted of an 8% decline in base growth and a 1% FX benefit.
- Dogs and cats revenue increased 10% y/y to \$342 MM.

Segment Earnings:

- U.S. earnings increased 8% y/y to \$234 MM.
- EuAfME earnings increased 13% y/y to \$117 MM, which consisted of 16% base growth and a 3% FX headwind.
- CLAR earnings decreased 4% y/y to \$52 MM, which consisted of 9% base growth and a 13% FX headwind.
- APAC earnings increased 6% y/y to \$75 MM.

Consolidated Earnings:

- Adjusted gross margin increased 54 basis points y/y to 63.49%, which was 51 basis points lower than our estimate of 64.00%.
- Adjusted operating income increased 15.6% y/y to \$274 MM, which was \$8.7 MM higher than our estimate of \$265.3 million.
- Adjusted operating margin increased 250 basis points y/y to 25.14%, which was 41 basis points higher than our estimate of 24.72%.
- Adjusted EPS of \$0.36 was \$0.02 higher than our estimate of \$0.34 and \$0.03 higher than consensus of \$0.33.

FY13 Guidance:

- Revenues are expected to be in a range of \$4,425 to \$4,525 MM.
- Adjusted cost of sales as a percentage of revenues are expected to be in a range of 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.
- 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	2Q13E	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	\$1,128.9	\$1,061.2	\$1,228.7	\$4,508.9	\$1,138.7	\$1,189.7	\$1,122.4	\$1,294.3	\$4,745.1	\$4,995.5
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	4.1%	3.2%	4.1%	4.5%	4.0%	4.5%	5.4%	5.8%	5.3%	5.2%	5.3%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-7.3%	3.6%	-6.0%	15.8%		-7.3%	4.5%	-5.7%	15.3%		
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	404.7	371.4	430.1	1,604.2	409.9	420.6	384.4	443.3	1,658.2	1,719.5
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	692.0	724.2	689.8	798.7	2,904.7	728.8	769.1	738.0	851.0	3,086.9	3,276.0
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	63.49%	64.15%	65.00%	65.00%	64.42%	64.00%	64.65%	65.75%	65.75%	65.05%	65.58%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	322.0	350.0	327.9	406.7	1,406.6	333.1	362.9	340.1	415.5	1,451.5	1,507.1
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	90.0	93.1	92.3	121.6	397.1	92.8	95.2	93.2	117.8	398.9	405.1
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	4.0	4.0	4.0	16.0	4.0	4.0	4.0	4.0	16.0	16.0
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	(7.3)	(7.3)	(7.3)	(19.8)	(7.5)	(7.5)	(7.5)	(7.5)	(30.0)	(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	439.9	417.0	525.1	1,800.0	422.4	454.5	429.8	529.7	1,836.4	1,896.2
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	274.0	284.4	272.8	273.6	1,104.7	306.4	314.6	308.2	321.2	1,250.5	1,379.8
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	25.14%	25.19%	25.71%	22.26%	24.50%	26.91%	26.44%	27.46%	24.82%	26.35%	27.62%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	22.0	31.0	31.0	31.0	115.0	31.0	31.0	31.0	31.0	124.0	120.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	252.0	253.4	241.8	242.6	989.7	275.4	283.6	277.2	290.2	1,126.5	1,259.8
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	23.12%	22.44%	22.79%	19.74%	21.95%	24.18%	23.84%	24.70%	22.43%	23.74%	25.22%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	73.0	74.1	71.9	72.8	291.8	81.2	83.7	81.8	85.6	332.3	371.6
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	28.97%	29.25%	29.75%	30.00%	29.48%	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	179.2	169.9	169.8	697.9	194.2	199.9	195.5	204.6	794.2	888.2
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	179.2	169.9	169.8	697.9	194.2	199.9	195.5	204.6	794.2	888.2
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	16.42%	15.88%	16.01%	13.82%	15.48%	17.05%	16.81%	17.41%	15.81%	16.74%	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	\$0.40	\$0.39	\$0.41	\$1.59	\$1.78
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.1	500.0	500.0	500.0	500.0	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%	18.2%	18.1%	19.1%	19.1%	18.6%	16.7%	16.3%	16.6%	15.9%	16.4%	14.6%
Depreciation and amortization	103.0	122.0	137.0	32.9	37.0	37.0	30.1	137.0	35.4	36.7	34.5	39.9	146.5	37.6	39.3	37.0	42.7	156.6	164.9
Adjusted EBITDA	426.0	617.0	940.0	268.9	311.0	287.0	212.1	1,079.0	309.4	321.0	307.3	313.5	1,251.3	344.0	353.9	345.3	364.0	1,407.1	1,544.7
Adjusted EBITDA Margin	15.43%	17.23%	22.21%	25.68%	28.43%	28.16%	18.04%	24.88%	28.39%	28.44%	28.96%	25.51%	27.75%	30.21%	29.74%	30.76%	28.12%	29.65%	30.92%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.51%	35.85%	35.00%	35.00%	35.58%	36.00%	35.35%	34.25%	34.25%	34.95%	34.42%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	29.54%	31.00%	30.90%	33.10%	31.20%	29.25%	30.50%	30.30%	32.10%	30.59%	30.17%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.26%	8.25%	8.70%	9.90%	8.81%	8.15%	8.00%	8.30%	9.10%	8.41%	8.11%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	38.35%	38.96%	39.29%	42.74%	39.92%	37.09%	38.21%	38.29%	40.93%	38.70%	37.96%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.25%	3.25%	3.25%	3.25%	3.25%	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%	5.9%	5.5%	0.7%	3.6%	3.0%	3.9%	3.5%	3.1%	3.4%	3.7%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	5.0%	1.7%	3.4%	6.6%	4.2%	5.3%	6.2%	7.0%	6.6%	6.3%	6.1%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	-2.7%	-0.3%	-0.6%	-7.6%	-3.1%	3.4%	3.7%	3.7%	2.2%	3.2%	3.8%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-3.2%	2.3%	-1.8%	0.5%	-0.5%	3.1%	2.2%	0.9%	-3.2%	0.5%	1.6%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	15.6%	3.8%	9.6%	50.3%	17.3%	11.8%	10.6%	13.0%	17.4%	13.2%	10.3%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	10.0%	-4.8%	-0.1%	39.4%	8.6%	9.3%	11.9%	14.7%	19.7%	13.8%	11.8%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.8%	1.8%	10.3%	197.9%	29.5%	8.5%	11.5%	15.1%	20.5%	13.8%	11.8%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.7%	1.8%	10.3%	197.9%	29.5%	8.5%	11.5%	15.1%	20.5%	13.8%	11.8%

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

April 30, 2013

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]	331	56.48	64	19.34
HOLD [N]	225	38.40	12	5.33
SELL [UW]	30	5.12	1	3.33

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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