

Zoetis Inc.

ZTS - BUY - Post July WASDE Report, We Continue to Expect Broiler & Hog Herd Expansion in 2014; Positive for ZTS

LOUISE CHEN, ANALYST

louise.chen@guggenheimpartners.com
212 381 4195

SWATI KUMAR, ASSOCIATE

swati.kumar@guggenheimpartners.com
212 918 8754

FLASH NOTE

SECTOR: Specialty Pharmaceuticals

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Lower prices for corn and soybean should drive livestock expansion for broilers and hogs in 2014. We hosted a conference call at 2:30p.m. ET yesterday with our WRG Agribusiness Analyst, Mark McMinimy, to discuss the July WASDE (World Agriculture Supply and Demand Estimates) data, which was released at noon ET yesterday. The July and August WASDE crop reports are closely watched for a current read on harvest prospects for 2013 crops and prices, which determine producers' decisions to expand herd sizes. Post the conference call, we are optimistic that livestock expansion for broilers and hogs will pick up in 2014 and cattle will pick up in 2015/2016. The possibility of broiler and hog expansion would be in line with our expectations. This is positive for Zoetis (ZTS, BUY, \$30.92), since ~ 66% of its sales are to the livestock industry. We are slightly less optimistic about the U.S. prospects for cattle expansion. The cattle slaughter statistics for female cows and calves do not yet point to a recovery, but we will not know for sure until the actual cattle report in January of 2014. **A replay of the conference call will be available for five business days after the call at toll-free U.S./Canada: 1-800-964-3261; Int'l Toll: 402-220-0605.**

- The July WASDE report suggests that the prospects of surplus crop production and much lower crop prices going into 2014, while not yet in hand, are very much on the horizon.
- We are entering the most weather-sensitive time of year for corn and soybean yields. Conditions over the next two months will go a long way to determining the harvest outcome.
- If these crop projections are realized in the wake of rebounding harvest results in South America, then, barring serious production shortfalls in other major producing areas of the world, the environment would be favorable for broiler and hog producers to move to an expansionary posture. Based on what we know now, we expect a 2.9% expansion for broilers and 3.1% expansion for hogs in 2014. The decision to expand would likely come at the end of the summer when the crops are in hand. Given the lag time between the decision to expand and cycle times (7 months for broilers, 12 months for hogs, 2 years for cattle), an actual increase would be weighted toward 2H14.
- Mark McMinimy's projected declines in 2013 crop corn and soybean meal prices of the order of roughly one-third each (expecting corn price of \$4.40/bushel to \$5.20/bushel, down from \$6.75 to \$7.15 in 2012) would augur for a rising ratio of live animal prices to feed costs, which should be a green light for expanding output.
- Poor forage conditions across much of the Plains appears to be derailing the possibility that U.S. ranchers will retain more female cattle for calf-bearing this year that would lead to an expansion in the national herd. Such an expansion now seems unlikely to occur before 2015, even if feed and forage conditions continue to improve. In addition to lower corn and soybean prices, cattle producers also need to see adequate forage (an important component of feed for cattle) to expand cattle herd sizes.
- The July WASDE report made relatively few changes that were incremental in scope in projections of crop production and prices compared with a month ago. That is not surprising since the weather has been relatively benign.

Potential Stock Moving Catalysts. 1) 2Q13 earnings, 8/6/13; 2) August WASDE report, 8/12/13; 3) new product launches; 4) expansion into adjacent categories; 5) U.S. drought subsidies; and 6) strong flea and tick season.

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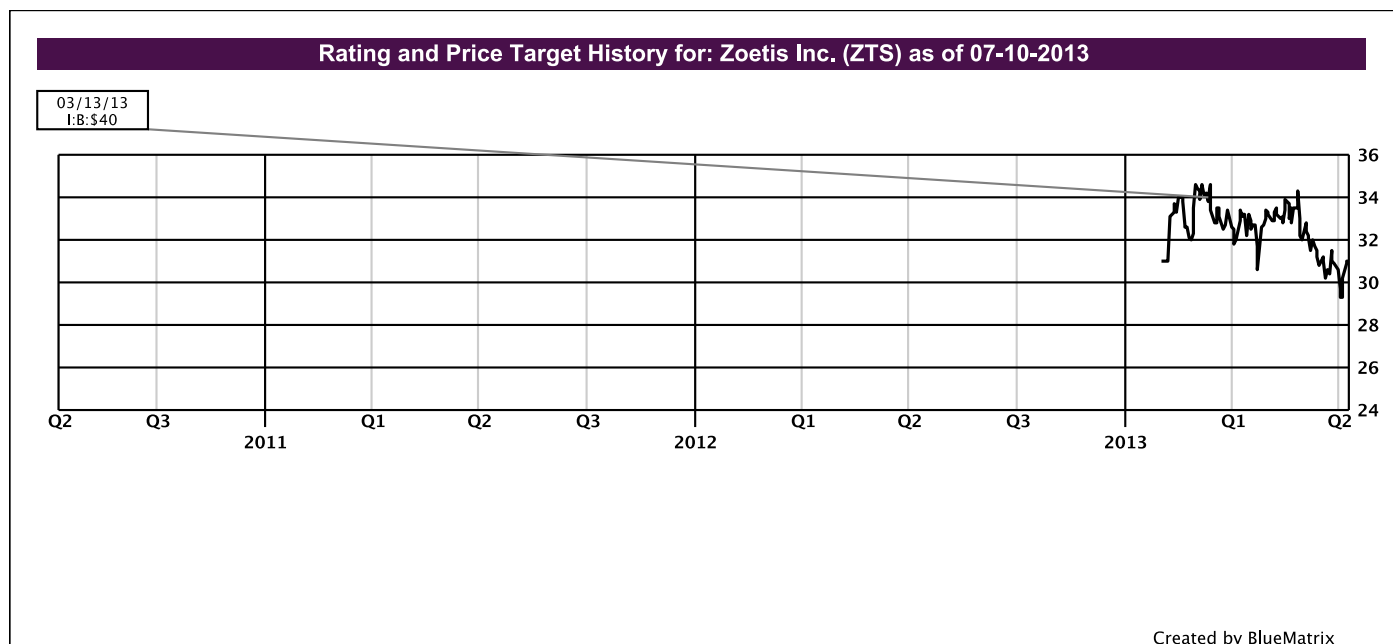
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Contact Information

NEW YORK SALES & TRADING DESK
212 292 4700

EQUITY TRADING DESK
212 292 4701

MEDIA INQUIRIES
312 977 4029

EMAIL
general@guggenheimmcm.com

Locations

NEW YORK
330 Madison Avenue
New York, NY 10017

CHICAGO
222 West Adams Street
Chicago, IL 60606

BOSTON
500 Boylston St, 13th Floor
Boston, MA 02116

LOS ANGELES
15821 Ventura Blvd
Encino, CA 91436
999 Corporate Drive
Ladera Ranch, CA 92694

DALLAS
1717 McKinney Avenue
Suite 870
Dallas, TX 75202

NASHVILLE
104 Woodmont Blvd
Suite 203
Nashville, TN 37205

HERNANDO
1288 Byhalia Road
Suite 2
Hernando, MS 38632

Guggenheim Equity Research

AUTOMOTIVE

Matthew Stover, Analyst
matthew.stover@guggenheimpartners.com
617 859 4605

Brendon Mason, Associate
brendon.mason@guggenheimpartners.com
617 859 4624

ENERGY: EXPLORATION & PRODUCTION

Rob Cordray, Analyst
robert.cordray@guggenheimpartners.com
972 638 5509

Steven Hader, Associate
steven.hader@guggenheimpartners.com
972 638 5507

ENERGY: OIL SERVICES & EQUIPMENT

Darren Gacicia, Analyst
darren.gacicia@guggenheimpartners.com
212 293 3054

Michael LaMotte, Analyst
michael.lamotte@guggenheimpartners.com
214 613 6700

FINANCIAL INDUSTRY GROUP

Rahul Agarwal, Associate
rahul.agarwal@guggenheimpartners.com
615 208 1221

Taylor Brodarick, Analyst
taylor.brodarick@guggenheimpartners.com
615 208 1222

David Darst, Analyst
david.darst@guggenheimpartners.com
615 208 1224

Marty Mosby, Analyst
marty.mosby@guggenheimpartners.com
662 469 9595

Mason Mosby, Associate
mason.mosby@guggenheimpartners.com
662 469 9595

HEALTHCARE: BIOTECH

Bret Holley, Analyst
bret.holley@guggenheimpartners.com
212 293 2820

HEALTHCARE: PHARMACEUTICALS

Louise Chen, Analyst
louise.chen@guggenheimpartners.com
212 381 4195

Swati Kumar, Associate
swati.kumar@guggenheimpartners.com
212 918 8754

RETAIL & CONSUMER

Steven Forbes, Associate
steven.forbes@guggenheimpartners.com
212 381 4188

John Heinbockel, Analyst
john.heinbockel@guggenheimpartners.com
212 381 4135

U.S. CABLE

Sabina Nyckowski, Analyst
sabina.nyckowski@guggenheimpartners.com
212 292 4778