

Zoetis Inc. (ZTS - \$31.13 - NYSE)

Q2 Results - Buy

Year	EPS ^(a)	P/E	PMV	Dividend: \$0.26	Current Return: 0.8%
2015P	\$1.80	17.3x	\$45	Shares O/S: 500.0 million	
2014P	1.65	18.9	40	52-Week Range: \$35.42 – \$28.97	
2013E	1.40	22.2	34		
2012A	1.08	28.9	---		

(a) Adjusted EPS excluding certain amortization charges, milestone payments, and other one-time charges

COMPANY OVERVIEW

Zoetis, located in Florham Park, NJ, is the world's largest animal health company. Zoetis manufactures and sells medicines for both production and companion animals. The company was spun out of Pfizer in February 2013.

Reason For Comment

On August 6, 2013 Zoetis reported in-line second quarter results with sales of \$1.1 billion (+1.8%, +4% ex-FX) and adjusted earnings of \$0.36 per share (vs. \$0.35 per share). The company also reaffirmed 2013 guidance.

- Excluding the negative impact of foreign currency, livestock sales of \$670 million grew 3% as strength for swine (+9%) and poultry (+9%) offset weakness in cattle (-2%). Due to the longer cycle time, cattle revenues continue to be impacted by the drought. Companion animal sales of \$444 million grew 5% despite the impact of a weaker flea/tick season in the second quarter.
- Excluding currency, global sales by geography include the US (\$437M, +4%), EuAfME (\$278M, +1%), CLAR (\$213M, +4%), and APAC (\$186M, +7%). With the exception of the US, sales growth was led by companion animal in each market.
- Gross margins were 64.1% for the quarter, down 100bp vs. 2012 but up 60bp sequentially. The company expects this trend of sequential gross margin improvement to continue, with guidance of 64-65% full-year gross margins. Lower operating costs helped offset the gross margin and increased interest costs, resulting in adjusted EPS of \$0.36.
- On June 24, Zoetis completed its separation from Pfizer through a stock-for-stock exchange. Following the exchange, Pfizer no longer owns any shares of Zoetis.
- The company maintained its guidance for adjusted earnings of \$1.36-1.42 per share for 2013. We continue to expect the company to earn \$1.40 per share in 2013, growing to \$2.25 by 2017 (16% 5-yr CAGR).
- We continue to recommend ZTS, as the company is uniquely positioned as a pure-play animal health company with exposure to higher-growth emerging markets. We expect Zoetis' earnings growth to be driven by 5% revenue growth and approximately 100 basis points of operating margin expansion annually through 2017. ZTS currently trades at 13.6x 2014 EBITDA and at a 23% discount to our 2014 PMV of \$40 per share.

Table 1

**Zoetis, Inc.
Income Statement
2010A – 2017P**

(\$ in millions, except per share data)

	2010A ^(a)	2011A ^(a)	2012A ^(a)	2013E	2014P	2015P	2016P	2017P	'13 - '17 CAGR
Net Sales	\$ 3,582	\$ 4,233	\$ 4,336	\$ 4,485	\$ 4,735	\$ 4,987	\$ 5,246	\$ 5,522	5.0%
% Growth	29.8%	18.2%	2.4%	3.4%	5.6%	5.3%	5.2%	5.2%	
EBITDA	593	924	1,068	1,235	1,381	1,492	1,609	1,729	10.1%
% Margin	16.6%	21.8%	24.6%	27.5%	29.2%	29.9%	30.7%	31.3%	
Adjusted EPS ^(b)	\$0.55	\$1.01	\$1.08	\$1.40	\$1.65	\$1.80	\$2.05	\$2.25	15.9%
% Growth	45.5%	82.9%	7.2%	29.9%	17.9%	9.1%	13.9%	9.8%	

(a) Pro forma for IPO

(b) Adjusted EPS, excludes certain non-cash items, restructuring, and certain one-time items, assume 500 million shares outstanding

Source: Company filings and Gabelli & Company estimates

Table 2

Zoetis, Inc.
Private Market Value Analysis
2012A – 2017P

(\$ in millions, except per share data)

	<u>2012A</u>	<u>2013E</u>	<u>2014P</u>	<u>2015P</u>	<u>2016P</u>	<u>2017P</u>
Production	\$ 2,806	\$ 2,871	\$ 3,017	\$ 3,171	\$ 3,328	\$ 3,492
Companion	1,530	1,614	1,718	1,815	1,919	2,030
Total Revenue	\$ 4,336	\$ 4,485	\$ 4,735	\$ 4,987	\$ 5,246	\$ 5,522
EBITDA	1,068	1,235	1,381	1,492	1,609	1,729
Valuation Multiple	16 x	16 x	16 x	16 x	16 x	16 x
Total Private Market Value	\$ 17,088	\$ 19,767	\$ 22,103	\$ 23,870	\$ 25,737	\$ 27,657
Less: Net Debt	(3,350)	(2,727)	(1,991)	(1,163)	(229)	802
Equity Private Market Value	\$ 13,738	\$ 17,054	\$ 20,137	\$ 22,740	\$ 25,553	\$ 28,514
Shares Outstanding	500	500	500	500	500	500
PMV Per Share		\$34	\$40	\$45	\$51	\$57
<i>Current Market - Discount to PMV</i>		8.7%	22.7%	31.6%	39.1%	45.4%

Source: Company filings and Gabelli & Company estimates

Other Companies Mentioned:

Pfizer (PFE – NYSE)

I, **Kevin Kedra**, the Research Analyst who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst's personal views about the subject companies and their securities. The Research Analyst has not been, is not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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Important Disclosures

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Analysts' ratings are largely (but not always) determined by our "private market value," or PMV methodology. Our basic goal is to understand in absolute terms what a rational, strategic buyer would pay for an asset in an open, arms-length transaction. At the same time, analysts also look for underlying catalysts that could encourage those private market values to surface.

A **Buy** rated stock is one that in our view is trading at a meaningful discount to our estimated PMV. We could expect a more modest private market value to increase at an accelerated pace, the discount of the public stock price to PMV to narrow through the emergence of a catalyst, or some combination of the two to occur.

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