

Gabelli & Company

Zoetis Inc. (ZTS - \$31.69 - NYSE)

Q3 Strong Across the Board - Buy

Year	EPS ^(a)	P/E	PMV	Dividend: \$0.26	Current Return: 0.82%
2015P	\$1.80	17.6x	\$45	Shares O/S: 500.0 million	52-Week Range: \$35.42 – \$28.81
2014P	1.65	19.2	40		
2013E	1.40	22.6	34		
2012A	1.08	29.4	---		

(a) Adjusted EPS excludes certain amortization, restructuring, and other non-cash or one-time expenses

COMPANY OVERVIEW

Zoetis, located in Florham Park, NJ, is the world's largest animal health company, with medicines for both production and companion animals. Zoetis completed its separation from Pfizer in May 2013.

Reason For Comment

On November 5, 2013, Zoetis reported third quarter results with revenue of \$1.1 billion (up 8%) and adjusted diluted earnings of \$0.34 per share (vs. \$0.30 per share). The company also provided an update to its financial guidance for 2013.

- Third quarter results were strong across all four geographic regions, with operational growth in the US (+10%), Europe/Africa/Middle East (+9%), Canada/Latin America (+9%), and Asia Pacific (+7%). This reflects continued execution as well as normalized weather following the negative effects of a drought in Q3 2012.
- Zoetis saw operational growth for both livestock (\$706 million, +8%) and companion animals (\$397 million, +11%). Livestock benefited from favorable comps with cattle (+7%) reversing its first-half declines as the market continues to recover from 2012's drought. Companion animal revenue benefited from price increases in the US and third party partnership revenues in Europe.
- Gross margins declined 20bp year over year but increased 120bp sequentially to 65.3%. Operating costs were slightly higher than expected due to SG&A of \$359 million, up both year over year and sequentially. However, this was partly due to a timing shift of promotional expenses for a late flea and tick season. SG&A expenses for the full year are still in-line with the company's guidance.
- For the full year, Zoetis narrowed its earnings guidance range to \$1.38-\$1.42 per share. We expect the company to meet the midpoint of this guidance at \$1.40 per share, growing to \$1.65 per share in 2014.
- We continue to recommend ZTS, as the company is well positioned with above-industry growth and exposure to emerging markets. We expect Zoetis to grow earnings at a 16% CAGR over the next five years, reaching \$2.25 per share in 2017. With several pharmaceutical companies talking about pursuing strategic options for businesses like animal health, we believe that industry consolidation could emerge as a catalyst. Zoetis currently trades at a 30% discount to our 2015 PMV of \$45 per share.

Table 1

Zoetis Inc. Income Statement 2010A – 2017P

(\$ in millions, except per share data)

	<u>2010A</u> (a)	<u>2011A</u> (a)	<u>2012A</u> (a)	<u>2013E</u>	<u>2014P</u>	<u>2015P</u>	<u>2016P</u>	<u>2017P</u>
Net Sales	\$ 3,582	\$ 4,233	\$ 4,336	\$ 4,485	\$ 4,735	\$ 4,987	\$ 5,246	\$ 5,522
% 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
% 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
% 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

-Please Refer To Important Disclosures On The Last Page Of This Report-

Table 2

Zoetis Inc
Private Market Value Analysis
2013E – 2017P

(\$ in millions, except per share data)

	<u>2013E</u>	<u>2014P</u>	<u>2015P</u>	<u>2016P</u>	<u>2017P</u>
Production	\$ 2,871	\$ 3,017	\$ 3,171	\$ 3,328	\$ 3,492
Companion	1,614	1,718	1,815	1,919	2,030
Total Revenue	\$ 4,485	\$ 4,735	\$ 4,987	\$ 5,246	\$ 5,522
EBITDA	1,235	1,381	1,492	1,609	1,729
Valuation Multiple	16 x	16 x	16 x	16 x	16 x
Total Private Market Value	\$ 19,767	\$ 22,103	\$ 23,870	\$ 25,737	\$ 27,657
Less: Net Debt	(2,727)	(1,991)	(1,163)	(229)	802
Equity Private Market Value	\$ 17,054	\$ 20,137	\$ 22,740	\$ 25,553	\$ 28,514
Shares Outstanding	500	500	500	500	500
PMV Per Share	\$34	\$40	\$45	\$51	\$57
<i>Current Market - Discount to PM</i>	<i>7.1%</i>	<i>21.3%</i>	<i>30.3%</i>	<i>38.0%</i>	<i>44.4%</i>

Source: Company filings and Gabelli & Company estimates

Other Companies Mentioned:

Pfizer Inc (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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Ratings

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.

A **Hold** is a stock that may be trading at or near our estimated private market value. We may not anticipate a large increase in the PMV, or see some other factors at work.

A **Sell** is a stock that may be trading at or above our estimated PMV. There may be little upside to the value, or limited opportunity to realize the value. Economic or sector risk could also be increasing.

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