HILLIARD LYONS

Pharmaceuticals
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Zoetis, Inc.

ZTS – NYSE – Neutral – 2

COMPANY UPDATE/ESTIMATE CHANGE
(April 30, 2013)

Key Metrics

ZTS - NYSE (Price as of 4/29/13)		$32.66
Price Target		NA
52-Week Range		$35.42 - $30.42
Shares Outstanding (mm)		512.9
Market Cap. ($mm)		$16,751
3-Mo. Average Daily Volume		3,532,300
Institutional Ownership		NA
Tot. Debt/Tot. Debt+Equity (9/12 pro-forma)		77.7%
ROE (2012E)		51.0%
Book Value/Share		$8.19
Price/Book Value (4/29/13)		3.99x
Indicated Dividend / Yield	$0.26	0.8%
LTM EBITDA Margin		24.4%

EPS FY 12/31

	Pro-forma			Prior	Curr.
	2011		2012E	2013E	2013E
1Q	--	--	--	--	$0.36A
2Q	--	--	--	--	--
3Q	--	--	--	--	--
4Q	--	--	--	--	--
Year	$0.90		$1.06	$1.35	$1.40
P/E	36.3x		30.8x	24.2x	23.3x

Note: Figures exclude non-recurring items

Revenue ($mm)

				Prior	Curr.
	2011		2012	2013E	2013E
1Q	--	--	--	--	$1,090A
2Q	--	--	--	--	--
3Q	--	--	--	--	--
4Q	--	--	--	--	--
Year	$4,233		$4,336	$4,555	$4,500

Company Description: *Zoetis operates the world's largest animal health business. Zoetis is involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals. The company sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific.*

Strong First Quarter Results

- **Zoetis is a global leader in the development, manufacture, and marketing of animal health medicines and vaccines**. The company's over 300 product lines focus on livestock, which includes cattle, poultry, swine, sheep, and fish, as well as companion animals. Key products are vaccines, parasiticides, anti-infectives, and other specialty products. More than 3,400 sales employees serve livestock producers and veterinarians in 70 countries.
- **Zoetis reported financial results for its first quarter as a public company separate from Pfizer**. First quarter revenue increased 4% to $1.09 billion from $1.05 billion in the first quarter of 2012. Currency reduced revenue growth by 1%.
- **Sales grew operationally in all geographies**. U.S. revenue increased 7%. Europe rose 5%. Canada and Latin America declined 1% but grew 4% in local currencies. Sales in Asia were up 1%.
- **By segment, both livestock and companion animal sales rose**. Livestock revenue increased 2% to $706 million with strong sales of swine and poultry products. Companion animal sales rose 8% to $384 million with double-digit growth of products for dogs and cats.
- **Earnings for the quarter exceeded expectations**. First quarter EPS of $0.36, excluding non-recurring items, rose from $0.30 last year and beat consensus expectations of $0.33.
- **Management provided revenue and earnings guidance for 2013**. Revenue for 2013 could be $4.425 to $4.525 billion with adjusted EPS in a range of $1.36 to $1.42. We have modestly lowered our revenue forecast but raised our 2013 EPS estimate by $0.05 to $1.40.
- **We are maintaining our Neutral rating.** ZTS is the first major participant in the global animal health business available to those interested in investing in the sector. ZTS is trading at 23 times our 2013 EPS estimate, an appropriate valuation, in our view.

Note Important Disclosures on Page 7.
Note Analyst Certification on Page 7.

Strategic Alternatives for Animal Health and Nutrition

Pfizer has pursued strategic alternatives for its Animal Health and Nutrition businesses. Management noted these are strong franchises on their own, but had different objectives from the core pharmaceutical businesses. As such, their strategic direction and value to Pfizer shareholders might be maximized by a spin-off, sale, or other transaction. Separation allows the company to focus on its global pharmaceutical and consumer medicines areas.

In December 2012, Pfizer completed the sale of its nutrition unit to Nestle for $11.85 billion. The segment is engaged in both infant and pediatric nutrition. It has operations across the globe, selling products in more than 60 countries. Its top markets are China, the Philippines, the United Kingdom, Mexico, and Australia. Emerging markets in Asia and Latin America have been the fastest growing in the nutrition area. Revenue for Pfizer Nutrition was $2.14 billion in 2011 versus sales of $1.87 billion in 2010, up 15%. By purchasing the business, Nestle solidified its position as the world's leading nutrition company. The ultimate price exceeded earlier expectations of about $10 billion.

Pfizer subsequently completed an initial public offering of a portion of its animal health business, which was named Zoetis. A minority stake in the unit was sold through the IPO. As part of the IPO, Pfizer exchanged Zoetis Class A common stock for Pfizer debt held by certain underwriters, who then sold the shares to the public. The stock was priced at $26 per share on the public offering. Trading began on February 1, 2013. PFE holds Zoetis Class B common stock, and retained approximately 80% ownership in the company. Class A and Class B common shares have identical voting rights except in the election of directors where Class B shares have ten votes per share while Class A shares have one. Each share of Class B Common held by Pfizer is convertible into a share of Class A. Zoetis will remain part of continuing operations for PFE's financial reporting for now. Going forward, PFE plans to ultimately distribute its remaining ownership to shareholders. One option is a split-off transaction in which shares in Zoetis could be exchanged for PFE stock, essentially accomplishing a share repurchase.

Zoetis recently reported final 2012 results. We have used this information to include revenue and adjusted operating income in our financial models. Pro-forma information adjusted for the separation from Pfizer was not provided, so we have continued to estimate Zoetis' EPS for 2012 as a hypothetical standalone company.

Overview of Zoetis

Zoetis operates the world's largest animal health business. Zoetis has been involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals for more than 60 years. The business sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific. International operations accounted for 59% of total revenue – Europe, Africa, and the Middle East (25%), Canada and Latin America (18%), and Asia Pacific (16%). Sales in emerging markets such as Brazil, China, and India amounted to 26% of revenue. Products are used in the livestock species of cattle, swine, poultry, sheep, and fish. In companion animals, the company makes products for dogs, cats, and horses.

Zoetis has a sales organization of approximately 3,400 employees. The organization consists of a network of technical and veterinary operations specialists. These individuals market the company's diverse portfolio of more than 300 products to livestock producers and veterinarians in 70 countries. No one product or line dominates Zoetis' sales. The company's largest product line, the antibiotic ceftiofur, accounts for less than 8% of revenue with Zoetis' top ten products accounting for less than 40% of sales. The company's main product lines are shown in Figure 2. The company generally uses a direct sales model, but engages distributors in markets without a commercial presence.

Figure 1. First Quarter 2013 Results
(figures in millions except per share amounts and percentages)

	First Quarter Ended Mar. 31 2013	Mar. 31 2012	% Chg.
Livestock	$ 706	$ 691	2.2%
Companion Animal	384	356	7.9%
Total Revenue	1,090	1,047	4.1%
Cost of Goods Sold	402	392	2.6%
Gross Profit	688	655	5.0%
Sell., Gen'l. & Admin.	322	331	(2.7%)
Research & Develop.	90	93	(3.2%)
Total Expenses	412	424	(2.8%)
Operating Income	276	231	19.5%
Interest Expense	(22)	(8)	- -
Other Income/(Deductions)	(2)	6	- -
Income before Taxes and Min. Interests	252	229	10.0%
Income Taxes	73	76	(3.9%)
Minority Interest	0	1	
Net Income	$179	$152	17.8%
Diluted EPS	$0.36	$0.30	20.0%
Avg. Number of Common Shares Outstanding	500.1	500.0	0.0%
Gross Margin	63.12%	62.56%	
Sell., Info. & Admin.	29.54%	31.61%	
Research & Develop.	8.26%	8.88%	
Operating Margin	25.32%	22.06%	
Tax Rate	28.97%	33.19%	

Note: Figures are from continuing operations and exclude non-recurring items
Source: Company reports

First Quarter Results

Zoetis reported financial results for its first quarter as a standalone company separate from Pfizer. First quarter 2013 results are compared to figures a year ago if ZTS had been separate from PFE at that time.

First quarter revenue increased 4% to $1.09 billion from $1.05 billion in the first quarter of 2012. Livestock revenue increased 2% to $706 million from $691 million last year. Double-digit growth was achieved in products for swine and poultry with cattle down 3%. Companion Animal sales were up 8% to $384 million versus $356 million. Products for dogs and cats grew 10% in the quarter. Adjusted for non-recurring items, operating income rose 20% in the quarter. The gross margin was higher at 63.1% versus 62.6% as margin improvement continued. SG&A declined 3% as the company is still benefiting from acquisition-related savings and cost management, partially offset by added expenses to develop infrastructure as a standalone company. Research spending also fell 3%.

Interest expense was much higher due to debt issued as part of the separation, so pretax income on the same basis increased 10%. Adjusted net income rose 18% on a lower tax rate. EPS of $0.36, excluding non-recurring items, rose from $0.30 last year and exceeded expectations of $0.33.

Non-recurring items impacted reported results. In the most recent quarter there were costs associated with the separation ($34 million), restructuring charges ($7 million), and amortization of intangible assets ($11 million), among other small items. A year ago, there were restructuring charges ($25 million), amortization of intangible assets ($12 million), and others. Including these items, reported EPS of $0.28 in the first quarter of 2013 compared to $0.22 last year.

By geography, U.S. sales rose 7% to $454 million from $425 million a year ago. Companion Animal sales increased 13% to $209 million with some benefit from a competitor supply issue. Livestock revenue was up 2% to $245 million, impacted by some lingering effect from the North American drought last year and its effect on domestic livestock producers.

Revenue from Europe, Africa, and the Middle East were up 5% to $290 million as currency added 1% to growth. Livestock sales grew 4% to $195 million with strength in swine and poultry. Companion Animal revenue increased 8% to $95 million.

Sales in Canada and Latin America declined 1% to $171 million, but rose 4% in local currencies. Brazil and Canada are the largest markets in this region with well developed livestock industries. Livestock sales grew 1% to $139 million due to sales of products for swine, poultry, and cattle. ZTS signed an agreement with a large cattle producer in Argentina to use *Clarifide* technology for genomic testing for better management of their herds. Companion Animal Sales fell 9% to $32 million.

In Asia pacific, revenue was $175 million, up 1%. Livestock sales rose 1% to $127 million. Strong sales of products for swine in Australia added to sales, offset by the impact of drought on southern Australia. Economic weakness in Japan also held back sales. ZTS launched the injectable antibiotic *Draxxin* in Japan during the quarter and registered the swine vaccine *Fostera PCV* for Porcine Circovirus Type 2. Companion Animal sales were flat at $48 million. In March, the company launched *Convenia*, an antibiotic for companion animals in China. *Convenia*, for use against bacterial skin infections, is a well established product sold in 50 countries.

Financial

Pro-forma balance sheet figures reflect the transactions with Pfizer as part of the separation. Pro-forma figures were not available for December 31, 2012, so we have continued to use the September 30, 2012 information to illustrate the impact on ZTS's financial condition from those transactions. Zoetis issued $3.64 billion in debt in order to transfer cash to Pfizer and retire $1 billion in existing Pfizer debt (See Figure 4). Following these transactions, Zoetis had $3.64 billion in long-term debt compared to $1.04 billion in shareholders' equity.

With organic growth and acquisitions, Zoetis has become a larger company over the last few years. Cash flow from operations in 2011 was almost $500 million, nearly double the 2010 amount, compared to capital expenditures of $135 million (See Figure 5).

For 2012, operating cash flow declined to $454 million from $497 million in 2011 due to the seasonal inventory building for cattle products and higher inventory levels of other targeted products. Capital expenditures of $126 million in 2012 were relatively modest in relation to cash flow. Management indicated its intention to pay a quarterly dividend of $0.065 per share to holders of both Class A and Class B common stock, subject to the discretion of the Board of Directors. Subsequently, the Board of Directors declared a $0.065 per share dividend for the second quarter of 2013, payable to shareholders on June 6, 2013.

Estimates

ZTS management provided 2013 revenue guidance in a range of $4.425 billion to $4.525 billion. Our 2013 revenue projection calls for continued single-digit U.S. revenue growth, assuming more normal weather patterns versus the 2012 drought. Some moderation in feed costs could occur as corn stocks were higher than expected and record corn planting is expected this year. European sales could benefit from stabilization in the euro versus the dollar, though some economic problems could persist. Growth in emerging markets is expected to continue. In all, we look for 2013 revenue of $4.50 billion, down from our earlier projection of $4.56 billion but up 4% from $4.34 billion in 2012. We expect margin improvement due to acquisition integration and synergies from acquisitions in recent years. We forecast a modest increase in the gross margin due to operational efficiencies and gains from acquisition integration. Management anticipates a small decline in SG&A despite costs to operate as a standalone company, compared to our original projection of higher SG&A spending. R&D could also decline modestly, as well. We incorporate a high level of interest expense resulting from the separation and a lower tax rate in our projection. Management provided an expected 2013 EPS guidance range of $1.36 to $1.42, excluding non-recurring items. With certain operating costs expected to be lower than we had originally estimated, we have raised our 2013 EPS estimate by $0.05 to $1.40.

Outlook

As a global provider of animal health products, Zoetis has numerous potential avenues to sustain revenue and earnings growth. With the company's large direct sales force, established customer relationships could result in market share gains and could facilitate the adoption of new products.

Along the same lines, Zoetis spends sizeable amounts on R&D and has been responsible for a significant percentage of new products within its industry. Continued new product development and introduction can enhance the existing product line and provide additional medicines and vaccines to be marketed by ZTS's sales force. Finally, the company's worldwide marketing capabilities could make Zoetis an attractive partner for licensing of new products and technologies.

Emerging markets are a potential source of revenue growth as standards of living improve and the demand for animal protein grows. Similar factors can spur additional spending on companion animals. The Asia/Pacific region has been the fastest growing for Zoetis. Canada and Latin America have performed well, though currency has been negative.

We look for ZTS to pursue complementary acquisitions. The addition of acquired businesses from Wyeth (Fort Dodge Animal Health) and King Pharmaceuticals (King Animal Health) boosted growth in 2010 and 2011, respectively. Smaller tuck-in acquisitions could add products, technology, or an expanded sales presence.

Conclusion

There are no large, publicly traded animal health companies similar to Zoetis to use as a benchmark valuation for Zoetis. Other such businesses are generally part of multinational pharmaceutical firms, similar to the case of Pfizer's ownership of Zoetis. As a standalone business, we have noted certain attractive characteristics of Zoetis. Revenue is fairly reliable due to the needs of livestock producers and pet owners. In addition, research is generally faster and less expensive because clinical studies are less expensive than for human pharmaceuticals. The business is typically self-pay as opposed to third party reimbursement in health care. Finally, there tends to be less generic competition and more brand loyalty. From a financial standpoint, we feel gross margins of over 60% and operating margins of over 20% are relatively high though below that of drug companies.

Zoetis shares were priced at $26 per share in the public offering, rose nearly 20% in the first day of trading, and are up 5% since then, though below recent higher prices. We would consider Zoetis a large capitalization growth stock with a strong market position and attractive growth prospects. As a proxy for valuing Zoetis, we looked at a group of companies deriving some or all of their business from the manufacture or distribution of animal care products. We have shown these in Figure 2. After reviewing the comparative valuations, the average P/E ratio is 23 times. With our higher estimate, the ZTS shares are currently trading at 23 times our 2013 EPS estimate, so we feel the stock is valued appropriately at this time and are maintaining our Neutral rating.

Figure 2. Comparative Valuation of Selected Animal Health Companies

			4/29/13	Earnings Per Share			% Chg	% Chg	P/E Ratio		2012	Market	Shares
	Sym	FY	Price	2011	2012	2013E	'11 - '12	'12 - '13E	2012	2013E	Revenue	Cap.	Out.
											(mil.)	(mil.)	(mil.)
Idexx Laboratories	IDXX	Dec.	$88.36	$2.75	$3.13	$3.44	13.8%	9.9%	28.2X	25.7X	$1,293	$4,831	54.7
MWI Veterinary Supply	MWIV	Sept.	$118.78	$3.41	$4.23	$4.86	24.0%	14.9%	28.1X	24.4X	$2,075	$1,520	12.8
Neogen Corp.	NEOG	May	$50.50	$0.96	$0.94	$1.13	(2.1%)	20.2%	53.7X	44.7X	$184	$1,205	23.9
Petsmart	PETM	Jan.	$66.81	$2.56	$3.55	$3.91	38.7%	10.1%	18.8X	17.1X	$6,758	$7,180	107.5
PetMed Express	PETS	Mar.	$12.72	$0.80	$0.84	$0.85	5.0%	1.2%	15.1X	15.0X	$233E	$254	20.0
Henry Schein	HSIC	Dec.	$89.94	$3.97	$4.43	$4.87	11.6%	9.9%	20.3X	18.5X	$8,940	$7,914	88.0
VCA Antech	WOOF	Dec.	$24.07	$1.36	$1.37	$1.55	0.7%	13.1%	17.6X	15.5X	$1,700	$2,113	87.8
Average							13.1%	11.3%	26.0X	23.0X			

Source: Baseline and Hilliard Lyons' Estimates

Risks and Considerations

Risks to our valuation include but are not limited to:

Restriction on use of animal medicines. Resistance to using anti-bacterials or other medicines in animals used for food could reduce demand and negatively impact revenue.

Conditions in the livestock industry. Unfavorable economics in the cattle, poultry, or swine markets could result in smaller herds and reduced demand for animal care products.

Weather extremes. Drought conditions can raise the cost of animal feed, leading to reductions in herd size.

Acquisition-related integration risks. Zoetis has augmented organic growth with acquisitions. Merging of different corporate cultures could make it difficult to achieve desired synergies.

Failure of new products. Zoetis spends a considerable amount on R&D to develop new products. Failure of products to achieve the desired result or reach the market could negatively affect revenue and earnings.

Economic activity. Rising standards of living, particularly in emerging markets, has increased the demand for animal protein. A weakening of the global economy could reduce this demand. Economic conditions can also affect the amounts consumers can spend on companion animals.

Operating as a separate entity. There will be additional expenses to operate as a standalone company. Pfizer plans to provide support initially, but Zoetis will ultimately be responsible for corporate functions.

High level of debt. Following the separation from Pfizer, Zoetis has $3.65 billion in debt compared to $1.04 billion in equity, along with a significant amount of interest expense.

Prices of stocks mentioned: Nestle (NSRGY - $71.25), Pfizer (PFE - $30.43).

Additional information is available upon request.

Analyst Certification

I, Stephen A. O'Neil, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in the common stock of Pfizer, but may not engage in buying or selling contrary to the recommendation.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	56	40%	13%	88%
Hold/Neutral	79	57%	13%	87%
Sell	4	3%	0%	100%

As of 10 April 2013

Other Disclosures

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