

Zoetis, Inc.

(ZTS - \$30.10)

July 31, 2013

Company Update Note

Medical Devices & Supplies

Strong Buy
\$41.00

Trading Data:

Last Price (7/31/2013)	\$30.10
52-Week High (3/14/2013)	\$35.42
52-Week Low (7/03/2013)	\$28.97
Market Cap. (MM)	\$15,020
Shares Out. (MM)	500
3 Month Avg. Daily Vol. (MM)	8.133

Earnings Estimates: (\$ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY14E	0.35	0.40	0.37	0.38	1.50
FY13E	0.36A	0.35	0.32	0.33	1.36
FY12A	0.30	0.35	0.30	0.12	1.08
FY11A	0.24	0.22	0.29	0.24	1.00

Valuation:

Multiple	Curr. FY	Next FY	Next FY @ PT
P/E	22.1	20.1	27.3
EV / EBITDA	14.0	12.4	16.4
EV / Revs.	3.9	3.6	4.7

Source: CL King & Associates estimates

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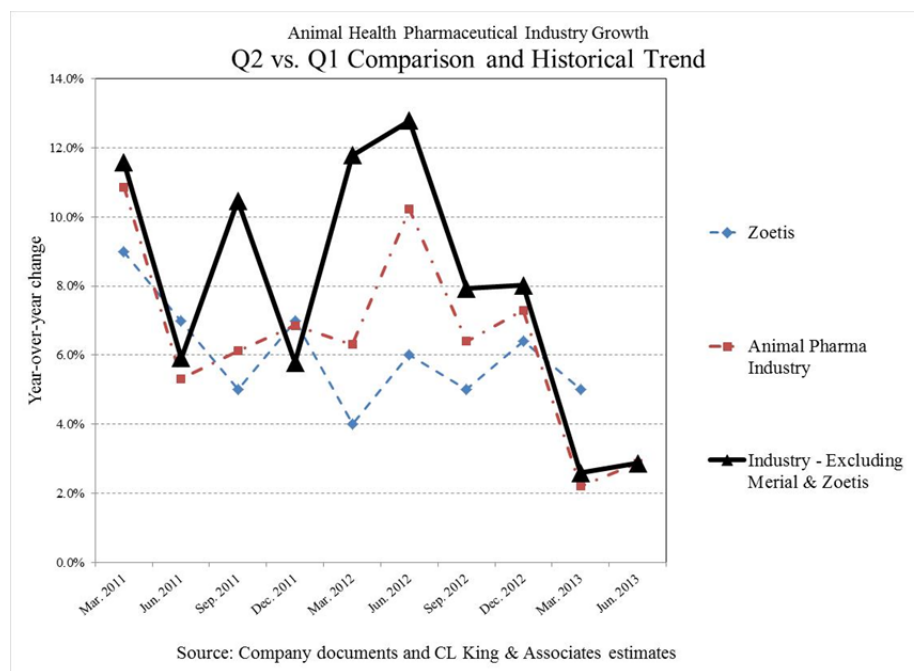
See required disclosures at the end of report.

Additional Data Points Suggest Industry Stability in Q2

- With the Q2 results from Bayer and Merck over the last two days, we think it is useful to update our estimates of growth trends in the animal pharmaceutical sector. Based on available data and our computations, we continue to estimate industry growth was stable in Q2 compared to Q1.
- Challenging conditions within the U.S. production animal industry resulting from the 2012 drought are one of several factors limiting growth this year. However, we believe the U.S. production animal sector is near the bottom of a trough and should grow in 2014.

Additional data suggests Q2 industry growth stable: With the June quarter financial results of Bayer (BAYN-ET: NR) this morning and Merck (MRK: NR) all of the major pharmaceutical companies have reported June quarter results with the exception of Merial, a unit of Sanofi (SNY: NR), and Zoetis. As shown in Chart 1 below, the weighted average organic growth rate for the companies that have reported June quarter results suggests the global animal pharmaceutical industry growth was about the same in Q2 as it was in Q1.

Chart 1: Animal Health Pharmaceutical Industry Growth – Q2 vs. Q1 and Historical Trends



Source: Company documents and CL King & Associates estimates

Note: Our data in Chart 1 includes Bayer, Eli Lilly, Merck, Vetoquinol (VETO-PA), and Virbac (VIRB-PA). We discussed qualitative results for Novartis in our July 18 note.

Source: Company documents and CL King & Associates estimates

Several factors are reducing industry growth in 2013: As has been known for many months, however, industry growth in the first half of 2013 was meaningfully below the level of calendar 2012. In our view, the primary causes of the lower growth are the impact of the 2012 U.S. drought and high feed prices, weak economic conditions in Europe, and possibly the comparison against last year's strong flea and tick season in the U.S.

We believe the U.S. production animal sector is at the bottom of a trough: Importantly, we believe the economic conditions within the U.S. production animal industry are at the bottom of a trough and should begin to show signs of improvement this fall. We note the management of MWI Veterinary Supply (MWIV**: SB\170) stated in its June quarter investor conference call that it expected the U.S. production animal industry to grow in calendar 2014 and that some segments should show good improvement as early as this fall. For additional details please refer to our July 30 research note on MWI Veterinary Supply.

In addition, as described in our animal health sector note of July 25, our analysis of commodity price data suggests that dairy and beef fundamentals should begin to improve before the end of this year. Also, within that note we highlighted some comments the management of Eli Lilly (LLY: NR) made during the company's June quarter investor conference call about the production animal sector that we view as more positive than the commentary during its March quarter conference call.

Highlighting our view that the animal pharmaceutical industry should begin to improve later this year: We emphasize we are not trying to make a "call" on Zoetis' June quarter results. Rather, we are trying to highlight our view that the U.S. production animal segment of the animal health industry should begin to improve this fall and that this sector should grow next year. Now that we are at the end of July, comparisons against last year's strong flea and tick season should be past. Finally, while the return of Novartis' (NVS^^: NR) Sentinel to the market in April may somewhat reduce sales of Zoetis' Revolution, we do not believe it will have an overly significant impact on Zoetis' financial results over the next few quarters. We estimate Revolution represents approximately 6.5% of Zoetis' total revenue, or approximately \$285MM.

Supplemental data: As supplemental information, we show our estimate of the organic growth rates for the various industry participants below.

Table 1: Organic Growth Rates by Company

<u>Company</u>	<u>2011A</u>	<u>2012A</u>	<u>Q1:13A</u>	<u>Q2:13A</u>
Organic growth rates:				
Bayer	5.1%	4.2%	3.4%	2.5%
Elanco (Eli Lilly)	19.6%	17.8%	2.7%	7.1%
Merck	7.6%	9.3%	4.0%	1.0%
Merial (Sanofi)	4.3%	3.1%	-3.1%	
Vetoquinol	-0.1%	1.6%	-1.4%	1.4%
Virbac	8.6%	8.1%	-2.3%	1.3%
Zoetis	7.0%	5.0%	5.0%	
Weighted average	7.7%	7.3%	2.2%	2.9%
Weighted average - excluding Merial & Zoetis	9.4%	9.9%	2.6%	2.9%

Source: Company documents and CL King & Associates estimates

Investment thesis and valuation: We believe Zoetis is well positioned to deliver stable, predictable and sustainable growth. We forecast the five-year compound annual growth in organic revenues and EPS should be at least 6% and 10%, respectively. We view Zoetis as an excellent investment in the growth of the animal health industry. Zoetis has many of the characteristics of the other high quality, growing animal health companies we follow. These include stable revenue growth, high margins and returns, and operations within an oligopolistic animal health industry segment. We project the global animal pharmaceutical industry should grow 6% annually over the next five years, driven by both the production animal and companion animal sectors. Also, we believe growth in developing economies and increasing global demand for protein should be an important source of the company's long-term growth. Emerging markets currently contribute 27% of Zoetis' revenues.

We believe in the current sluggish macroeconomic environment investors will continue to be attracted to companies like Zoetis that are able to deliver steady revenue and earnings growth driven by unit growth and pricing power adequate to offset cost inflation. Furthermore, we anticipate healthcare investors will continue to be attracted to companies that are insulated from reimbursement pressure from the government and other third parties. We believe Zoetis' industry-leading position and high market share should facilitate its growth and help mitigate risk. In addition, we believe the company's high level of R&D spending and large direct sales and marketing organization help create sustainable competitive advantages. Valuation data is in the table below.

Table 2: Valuation Multiples for Zoetis

<u>Item</u>	<u>2012PF</u>	<u>2013E</u>	<u>2014E</u>
Stock price	\$30.10	\$30.10	\$30.10
Revenues (in 1,000's)	\$4,336,000	\$4,562,840	\$4,878,018
EBITDA (in 1,000's)	\$1,105,000	\$1,281,428	\$1,406,543
EPS - GAAP	\$1.01	\$1.29	\$1.42
EPS adj to add back amortization exp.	\$1.08	\$1.36	\$1.50
P / E ratio - based on adj. EPS	27.9 x	22.2 x	20.0 x
EV / EBITDA ratio	16.5 x	14.0 x	12.4 x
EV / Revenue ratio	4.2 x	3.9 x	3.6 x
ROA	9.2%	11.0%	12.0%
ROE	22.2%	49.2%	38.7%
Enterprise value computation:			
Equity market value (in 1,000's)	\$15,050,000	\$15,292,464	\$15,445,963
Total debt (in 1,000's)	\$3,640,000	\$3,340,000	\$2,540,000
Cash (in 1,000's)	\$484,000	\$730,552	\$544,019
Enterprise value (in 1,000's)	\$18,206,000	\$17,901,912	\$17,441,944

Source: CL King & Associates estimates

Risks: There are a number of potential risks that could have a negative affect on Zoetis' business and its stock. To begin, there is a risk regulators could impose new restrictions on the use of antibiotics in production animals due to concerns about antimicrobial resistance in humans. Similarly, changes in consumer views of products from animals treated with antibiotics could also impact Zoetis' business. Also, the production animal and companion animal markets are sensitive to the economy, so if the economy weakens materially

Zoetis' revenues and income may be lower than we project. Furthermore, severe weather conditions such as drought could negatively affect Zoetis' production animal business. For example, drought can result in higher grain and feed prices and reduce available grazing pastures, either one of which could result in a reduction of beef and dairy cattle herds. Within our financial forecasts we project Zoetis' margins should expand over the next several years. There is a risk the company may not be successful in improving margins as much as we expect. Also, the company may not be as effective as we project in managing its operations and expenses during its process of fully separating from Pfizer (PFE: NR).

Previous research update – 6/17/13

DISCLOSURES:

ANALYST CERTIFICATION

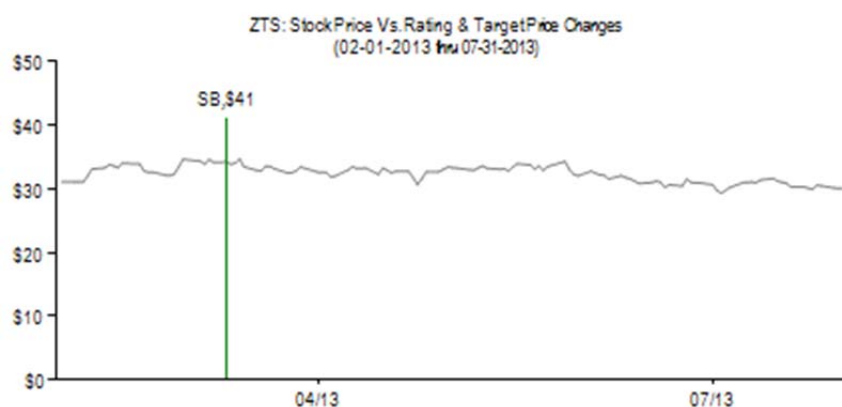
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Additional information available upon request.

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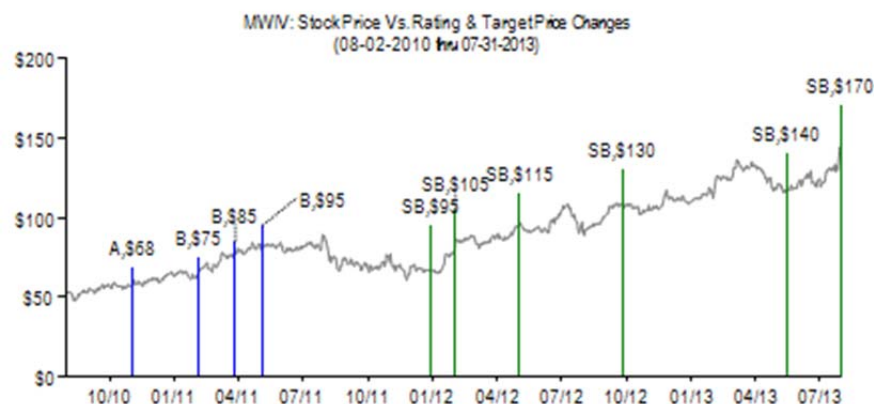
RATINGS INFORMATION**Rating and Price Target Change History****3 Year Rating Change History**

Date	Rating	Closing Price, (\$)
03/11/2013	Strong Buy (SB)	34.18

3 Year Price Change History

Date	Target Price	Closing Price, (\$)
03/11/2013	41.00	34.18

Source: CL King & Associates, Created by: www.ResearchMaestro.net

**3 Year Rating Change History**

Date	Rating	Closing Price, (\$)
11/04/2010	Accumulate (A)	61.02
02/03/2011	Buy (B)	64.36
12/28/2011	Strong Buy (SB)	66.32

3 Year Price Change History

Date	Target Price	Closing Price, (\$)
11/04/2010	68.00	61.02
02/03/2011	75.00	64.36
03/28/2011	85.00	77.90
05/05/2011	90.00	81.98
05/05/2011	95.00	81.98
12/28/2011	95.00	66.32
02/02/2012	105.00	86.23
05/03/2012	115.00	96.49
09/25/2012	130.00	107.62
05/16/2013	140.00	118.34
07/30/2013	170.00	143.67

Source: CL King & Associates, Created by: www.ResearchMaestro.net

Note: Prior to 02/01/2011 Buy was Accumulate
Prior to 02/01/2011 Sell was Underperform

CL King Rating System		% of Companies Under Coverage With This Rating	% of Companies for which CL King has performed services for in the last 12 months	
			Investment Banking	Brokerage
Strong Buy (SB)	Analyst believes shares will appreciate by 20% or more over the next 6-12 months and should significantly outperform the broader market averages. Analyst believes the risk of long-term capital impairment is below-average.	14.69%	0.00%	2.10%
Buy (B)	Analyst believes shares will appreciate in a range of 10% to the upper teens over the next 6-12 months and will outperform the broader capital market averages. Analyst believes the risk of long-term capital impairment is below-average, but not as low as it is for Strong Buy.	37.76%	1.40%	0.70%
Neutral (N)	Analyst believes the current stock price fairly discounts the company's prospects over the next 6-12 months, give or take 10%, and will trade in-line with the broader market averages. Analyst believes the risk of permanent capital impairment is about average.	46.85%	1.40%	1.40%
Sell (S)	Analyst expects the stock price to decline 10% or more over the next 6-12 months and to underperform the broader market averages.	0.70%	0.00%	0.00%

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