

Pharmaceuticals

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COMPANY UPDATE (August 6, 2013)

Kev Metrics

Key Metrics		
ZTS - NYSE (Price as of 8/5/13)		\$31.25
Price Target		\$36.00
52-Week Range	\$35.42	2 - \$28.97
Shares Outstanding (mm)		500.0
Market Cap. (\$mm)		\$15,625
3-Mo. Average Daily Volume	-	7,364,720
Institutional Ownership		97.0%
Tot. Debt/Tot. Debt+Equity (3/13)		83.7%
ROE (2012)		NA
Book Value/Share		\$1.43
Price/Book Value (8/5/13)		21.82x
Indicated Dividend / Yield	\$0.26	0.8%
LTM EBITDA Margin		25.5%

EPS FY 12/31

	Pro-forma 2012	Prior 2013E	Curr. 2013E	Prior 2014E	Curr. 2014E
1Q		\$0.36A	\$0.36A		
2Q			\$0.36A		
3Q					
4Q					
Year	\$0.97	\$1.40	\$1.40		\$1.60
P/E	32.2x	22.3x	22.3x		19.5x

Note: Figures exclude non-recurring items

Revenue (\$mm)

		Prior	Curr.	Prior	Curr.
	2012	2013E	2013E	2014E	2014E
1Q	\$1,047	\$1,090A	\$1,090A		
2Q			\$1,114A		
3Q					
4Q					
Year	\$4,336	\$4,500	\$4,500		\$4,725

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.

Zoetis, Inc.

ZTS - NYSE - Buy - 3

Second Quarter EPS Met Expectations with Strong Operating Margins

- 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 the second quarter. Second quarter revenue increased 2% to \$1.11 billion from \$1.09 billion in the second quarter of 2012. Currency reduced revenue growth by 2%.
- Sales grew in all but one region. U.S. revenue increased 4%. Canada and Latin America rose 1%. Sales in Asia were up 4%. Europe declined 2%.
- Both livestock and companion animal sales rose. Livestock revenue increased 1% to \$670 million with strong sales of swine and poultry products. Companion animal sales rose 3% to \$444 million with single-digit growth of products for dogs and cats.
- Earnings for the quarter met expectations. The second quarter operating margin of 25.2% improved from 24.4% a year ago. EPS of \$0.36, excluding non-recurring items, rose from \$0.35 last year and matched consensus expectations of \$0.36.
- Management reaffirmed 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 maintained our revenue forecast at \$4.5 billion. Our 2013 EPS estimate is \$1.40.
- Zoetis is rated Buy. 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 22 times our 2013 EPS estimate. We arrive at our \$36 per share price target by using our 2014 EPS estimate of \$1.60 and assuming ZTS could at least maintain or possibly improve on its current valuation.

Note Important Disclosures on Page 7 and 8. Note Analyst Certification on Page 6.

EQUITY RESEARCH

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 for \$11.85 billion.

In February 2013, Pfizer completed an initial public offering of a portion of Zoetis, its former animal health business. 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. PFE subsequently distributed its remaining ownership to shareholders in a split-off transaction in which shares in Pfizer were exchanged for ZTS stock, essentially accomplishing a share repurchase.

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 2012 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 generally uses a direct sales model, but engages distributors in markets without a commercial presence.

Second Quarter Results

Zoetis reported financial results for the second quarter of 2013. Results are compared to figures a year ago if ZTS had been separate from PFE at that time.

Second quarter revenue increased 2% to \$1.11 billion from \$1.09 billion in the second quarter of 2012 with currency a 2% drag on growth. Livestock revenue increased 1% to \$670 million from \$665 million last year. High single-digit growth was achieved in products for swine and poultry with cattle down 4%. Companion Animal sales were up 3% to \$444 million versus \$429 million. Products for dogs and cats grew 5% in the quarter while sales of equine products declined.

Figure 1. Second Quarter 2013 Results

(figures in millions except per share amounts and percentages)

	Second Quarter Ended		Six Month			
	June 30	June 30	%	June 30	June 30	%
	2013	2012	Chg.	2013	2012	Chg
Livestock	\$ 670	\$ 665	0.8%	1,376	1,356	1.5%
Companion Animal	444	429	3.5%	828	785	5.5%
Total Revenue	1,114	1,094	1.8%	2,204	2,141	2.9%
Cost of Goods Sold	403	385	4.7%	805	777	3.6%
Gross Profit	711	709	0.3%	1,399	1,364	2.6%
Sell., Gen'l. & Admin.	339	351	(3.4%)	661	682	(3.1%)
Research & Develop.	91	91	0.0%	181	184	(1.6%)
Total Expenses	430	442	(2.7%)	842	866	(2.8%)
Operating Income	281	267	5.2%	557	498	11.8%
Interest Expense	(32)	(8)		(54)	(16)	
Other Income/(Deductions)	3	7		1	13	
Income before Taxes						
and Min. Interests	252	266	(5.3%)	504	495	1.8%
Income Taxes	74	90	(17.8%)	147	166	(11.4%)
Minority Interest	0	0		0	1	
Net Income	\$178	\$176	1.1%	\$357	\$328	8.8%
Diluted EPS	\$0.36	\$0.35	1.1%	\$0.71	\$0.66	8.8%
Avg. Number of Common						
Shares Outstanding	500.2	500.0	0.0%	500.2	500.0	0.0%
Gross Margin	63.82%	64.81%		63.48%	63.71%	
Sell., Info. & Admin.	30.43%	32.08%		29.99%	31.85%	
Research & Develop.	8.17%	8.32%		8.21%	8.59%	
Operating Margin	25.22%	24.41%		25.27%	23.26%	
Tax Rate	29.37%	33.83%		29.17%	33.54%	

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

Source: Company reports

Adjusted for non-recurring items, operating income rose 5% in the quarter. The gross margin was lower at 63.8 % versus 64.8% likely due to product mix. SG&A declined 3% as the company is still benefiting from savings gained from previous acquisitions as well as cost management, partially offset by added expenses to develop infrastructure as a standalone company. Research spending was flat at 8.2% of revenue. Interest expense was much higher due to debt issued as part of the separation, so pretax income on the same basis declined 5%. Adjusted net income rose 1% on a lower tax rate. EPS of \$0.36, excluding non-recurring items, rose from \$0.35 last year and matched expectations of \$0.36.

Non-recurring items impacted reported results. In the most recent quarter there were costs associated with the separation (\$60 million), restructuring charges (\$7 million), and amortization of intangible assets (\$12 million), among other small items. A year ago, there were restructuring charges (\$13 million), amortization of intangible assets (\$13 million), and others. Including these items, reported EPS of \$0.26 in the second quarter of 2013 compared to \$0.35 last year.

By geography, U.S. sales rose 4% to \$437 million from \$421 million a year ago. Companion Animal sales increased 2% to \$233 million as a competitor resolved a supply issue. Sales growth of small animal products was partially offset by contraction in the equine market. The FDA approved *Apoquel* for treating allergic dermatitis in dogs. Livestock revenue was up a strong 6% to \$204 million despite some lingering effect from the North American drought last year and its effect on domestic livestock producers. Price increases appear to be holding. Separately, *Draxxin 25* antifective solution for swine and *Bovi-Shield Gold One Shot*, a vaccine for respiratory diseases in cattle, were approved in the U.S.

Revenue from Europe, Africa, and the Middle East was down 2% to \$278 million as currency subtracted 3% to growth. Livestock sales fell 5% to \$184 million due to lower sales of cattle products. Cold weather conditions delayed the sales of parasiticides. Overall economic weakness was a factor, as well. Companion Animal revenue increased 4% to \$94 million aided by increased sales as part of third party manufacturing agreements.

Sales in Canada and Latin America increased 1% to \$213 million, but rose 4% in local currencies. Brazil and Canada are the largest markets in this region with well developed livestock industries. Livestock sales fell 1% to \$153 million due to higher sales of products for swine and poultry while cattle products declined. The swine vaccine *Fostera PCV* for Porcine Circovirus Type 2 was approved in Brazil. 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 rose 5% to \$60 million due to increased demand from marketing programs in Brazil and Mexico, partially offset by lower sales in Canada.

In Asia Pacific, revenue was \$186 million, up 4% and up 7% in local currencies. Livestock sales rose 2% to \$129 million. Strong sales of products for swine and the launch of new vaccines contributed. The drought in southern Australia impacted cattle product sales. ZTS launched the injectable antibiotic *Draxxin* in Japan during the quarter while the swine vaccine *Fostera PCV* for Porcine Circovirus Type 2 was approved in Japan. The company's joint venture in China received approval for *Rui Lan An*, a vaccine for porcine reproductive and respiratory syndrome. 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

Balance sheet figures reflect the transactions with Pfizer as part of the separation. Zoetis issued \$3.64 billion in debt in order to transfer cash to Pfizer and retire \$1 billion in existing Pfizer debt. Following these transactions, Zoetis had \$3.64 billion in long-term debt at the end of March 2013 compared to \$709 million 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.

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. New product launches could add to sales. Growth in emerging markets is expected to continue. In all, we look for 2013 revenue of \$4.50 billion, 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 for the year 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. 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. Our 2013 EPS estimate is \$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 25% are relatively high though below that of drug companies.

Zoetis is rated Buy. We view Zoetis as 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. After reviewing the comparative valuations, the average P/E ratio is about 23 times. We feel Zoetis might receive a premium due to its size, global reach, and strong market position. With the ZTS shares currently trading at 22 times our 2013 EPS estimate, we feel the stock is attractive. Our price target is \$36 per share. We arrive at our target by using our 2014 EPS estimate of \$1.60 and assuming ZTS could at least maintain or possibly improve on its current valuation.

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 \$3.64 billion in debt compared to \$684 million in equity, along with a significant amount of interest expense.

Prices of stocks mentioned: Pfizer (PFE - \$29.19).

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



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

	Hilliard Lyons Recommended Issues			Investment Banking Provided in Past 12 Mo.		
	# of	% of				
Rating	Stocks Covered	Stocks Covered	Banking	No Banking		
Buy	48	35%	17%	83%		
Hold/Neutral	82	59%	13%	87%		
Sell	8	6%	0%	100%		
Restricted	1	1%	100%	0%		

As of 5 August 2013

Other Disclosures

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