Zoetis

Best Of Breed; Initiating with Overweight Rating and $39 Price Target

Initiation
Overweight
ZTS, ZTS US
Price: $33.82
Price Target: $39.00

Pharmaceuticals — Major & Specialty

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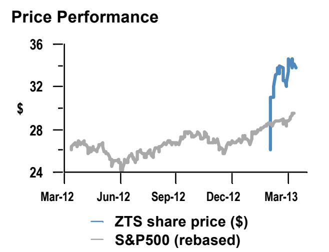

We are initiating coverage of ZTS shares with an Overweight rating and $39 YE '13 price target. Zoetis, a spin-out of Pfizer's animal health division, holds a clear leadership position within its industry and operates a business model that we believe is capable of generating sustainable mid-single digit top-line growth and low to mid-teens EPS growth. Further, we see Zoetis as a fairly unique asset within the healthcare space with a highly diversified portfolio, a significant emerging markets presence, and lack of third-party payer or generic exposure.

- **Zoetis holds a clear leadership position in an attractive animal health market.** We see the $20+ billion animal health market that Zoetis competes in as capable of producing mid-single digit top-line growth, driven by a mix of volume as well as price increases and new product introductions. Macro trends supporting this growth assumption include rising global consumer demand for meat and dairy products as well as higher pet ownership and pet spending levels. With over $4 billion in 2012 sales, Zoetis is a clear leader within the industry with a top three position in every major geography and product category.
- **Zoetis' business offers several advantages over traditional pharma.** Animal health products do not face the same post-patent expiration cliff as traditional pharmaceutical products and the industry has limited exposure to government or third party payer risk. Further, new product development within animal health is supported by less expensive and less risky R&D cycles. In our view, these factors should translate to highly sustainable growth for Zoetis as compared to the patent expiration-tied cycle of the traditional human pharmaceutical model.
- **We see a significant margin expansion opportunity for Zoetis.** Zoetis has built a global direct sales infrastructure and already spends at industry leading levels on R&D and we see limited need for significant incremental expense growth as the company's top line grows. Along these lines, we forecast roughly 800 basis points of operating margin expansion from Zoetis through 2017 to 30%.
- **Our $39 price target is DCF based.** We are forecasting 12% EPS growth for the company through 2017 based on a combination of mid-single digit top-line growth and margin expansion. Our price target translates to a multiple of 28x our 2013 EPS estimate of $1.40 and 24x-25x our 2014 EPS estimate of $1.60.

Zoetis (ZTS;ZTS US)

FYE Dec	2012E	2013E	2014E
EPS Adjusted ($)			
Q1 (Mar)	-	0.34	-
Q2 (Jun)	-	0.35	-
Q3 (Sep)	-	0.37	-
Q4 (Dec)	-	0.35	-
FY	-	1.40	1.60
Bloomberg EPS FY ($)	1.27	1.26	1.38

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
Price ($)	33.82
Date Of Price	12 Mar 13
52-week Range ($)	34.89 - 26.00
Mkt Cap ($ mn)	17,079.10
Fiscal Year End	Dec
Shares O/S (mn)	505
Price Target ($)	39.00
Price Target End Date	31 Dec 13

See page 47 for analyst certification and important disclosures.

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Investment Thesis

Zoetis (ZTS)

Overweight

The animal health market is an attractive one . . .

With roughly 7% annual growth over the past five years and mid-single digit annual growth expected over the next several years, we see the animal health market as an attractive investment opportunity. Favorable macro trends such as the growth of a global middle class which consumes higher amounts of meat-based protein and dairy as well as higher pet ownership and pet spending support this continued growth. In addition, animal health products represent a small piece (2-3%) of a producer's expenses but have a large impact on investments these organizations make in their herd, creating a strong rationale for their use.

. . . and Zoetis is a clear leader in the space.

Zoetis is the clear market leader in the $20+ billion animal health industry with over $4 billion in 2012 sales. From a market share standpoint, the company holds the #1 position in every major region of the world except for Europe (#2) and is a top 3 player in every relevant sub-sector of the industry. In our view, there are clear advantages to scale in the animal health industry and we believe the company's market leading position should allow for at least industry average growth and superior margins over time.

We see animal health as less exposed to many of the negative pressures facing the human pharma business.

In particular, we see several key characteristics distinct to the animal health industry that compare favorably with human pharma including: (1) the lack of an established generics industry/infrastructure, (2) limited government or third party payer exposure, and (3) shorter, less expensive and less risky R&D cycles. These factors should translate to a highly sustainable growth profile for the animal health industry as compared to patent expiration cycle impacted human pharmaceutical model.

Margin expansion is key to the Zoetis story.

We see the potential for significant operating margin expansion at Zoetis over the next five years and see this margin improvement as a key earnings driver for the company. Zoetis has built a global direct sales infrastructure and already spends at industry leading levels on R&D. Along these lines we see limited need for significant incremental investment as the company's top line grows and forecast operating income growth at roughly twice the rate of sales growth. This translates to operating margin expansion to roughly 30% by 2017, up 800 bps from estimated 2012 levels. While limited data is available given the lack of public comparables, it appears Zoetis' operating margins are below many of its peers. We see this as an opportunity and believe Zoetis' margins should be at the high end of the industry over time given the company's scale advantages.

Overall, we anticipate a 6% top line and 12% EPS CAGR for Zoetis through 2017.

The company's business is highly diversified.

Zoetis' diversification represents one of the most attractive features of the company business in our view. The company has a broad geographic footprint with 60% of sales generated outside the US and 27% of sales generated in emerging markets, which is the highest level of any name in our coverage universe. In addition, Zoetis is diversified from a product, category, and species standpoint with its largest product representing only 8% of sales and its top ten products contributing less than 40% of sales. As a result of this diversification, we see the company as less exposed to any single risk factor. For example, we estimate the record 2012 drought in the United States (the company's largest region) had only a 1%-2% impact on Zoetis's top-line results.

With limited public comparables, we use DCF as our primary valuation metric.

Our $39 price target for Zoetis is based on our DCF (see pages 6-7 for more details) with the company's mid-single digit top-line growth and substantial margin expansion through 2017 representing key drivers of our valuation. We would note that Zoetis is one of only three companies in our coverage universe (AGN and PRGO being the other two) where we assume a modestly positive terminal growth rate (2.5%). This is due to the macro drivers supporting volume growth for the company's products as well as the lack of true generic competition in the animal health space.

From a comparable standpoint, Zoetis is the only large, publically traded animal health company (although there are several smaller names) and there is no one perfect comp group for the name. However, we looked across the healthcare sector (and beyond) for companies that had other similarities to the profile we see with Zoetis, i.e., durable, non-patent cliff exposed franchises, cash-pay businesses, and similar long-term macro drivers in a growing middle class globally. Within this framework, we see Allergan, Perrigo, Monsanto, and Mead Johnson (latest major pharma spin) as the best available group of valuation comparables. This group trades at 22x and 20x 2013 and 2014 EPS respectively as compared to Zoetis at 24x and 21x.

We would not be surprised if Pfizer were to split off Zoetis later in 2013.

While Pfizer has not announced specific plans for its remaining roughly 80% stake in Zoetis, we view the Mead Johnson split from Bristol-Myers Squibb in 2009 as a model for Pfizer's disposition of its remaining stake in Zoetis (see pages 10-11 for additional details). Pfizer is unable to pursue such a separation until 180-days post the ZTS IPO (i.e., August 2013) but at current valuations, such a share exchange could be roughly $0.08 accretive to Pfizer's annual earnings.

Risks to Rating and Price Target

Limited operating history.

Zoetis has been assembled through a series of Pfizer acquisitions over the past few years including Wyeth's Fort Dodge business and King's animal health franchise. As a result of these acquisitions as well as build out of the company's direct selling infrastructure, Zoetis' current margins are lower than many of its peers. Our positive investment thesis on Zoetis is based partially on the company's ability to expand its operation margins from current levels, something that may be difficult to achieve.

Zoetis must separate its operations from Pfizer over the next several years.

Much of Zoetis' operations are distinct from Pfizer, including functions such as sales and marketing as well as R&D. However, the company will need to build its own

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infrastructure in several areas (particularly back office) over the next several years. In addition, a portion of Zoetis' manufacturing operations are located within Pfizer facilities. While Zoetis will be provided these products at cost through 2015, the company will face a 15% step-up in cost associated with product remaining at these facilities beyond this time.

Zoetis' business is subject to weather, commodity and economic related volatility.

Weaker economic conditions can reduce demand for Zoetis' livestock business more so than traditional human pharmaceutical businesses. In addition, higher feed prices could result in producers reducing overall herd size as we have seen in the United States over the past year due to a record drought.

Lower antibiotic usage could impact Zoetis' anti-infective business.

Zoetis is the leading producer of antibiotics for animal use and there are growing efforts to reduce use of these products in several markets including Europe and the United States. This is particularly the case with the use of antibiotics in healthy animals where the products are used prophylactically and for growth promotion.

Pfizer remains a majority shareholder of Zoetis.

Following the Zoetis IPO, Pfizer continues to hold over 80% of outstanding ZTS shares and disposition of those shares could put pressure on Zoetis' stock.

Company Description

Zoetis is the global market leader in the animal health space. The company develops, manufactures and sells medicine and vaccines for both livestock and companion animals. In 2012, the company generated revenue of over $4 billion with sales coming from 120 countries and across multiple product categories including anti-infectives, parasiticides, vaccines, and medicinal feed additives.

Valuation

Consistent Top-line Growth Coupled with Margin Expansion Supports $39 Price Target

Our $39 price target for Zoetis is based on our DCF with the company's mid-single digit top-line growth and substantial margin expansion over the next 5-7 years representing key drivers of our valuation. We assume that Zoetis is able to generate at least industry average top-line growth over the next several years based on the company's global scale as well as its industry leading R&D investment. We are anticipating relatively modest expense growth over this same time horizon as we see limited need for substantial expansion of either Zoetis' sales efforts or overall R&D expense levels. This combination should translate to meaningful operating margin expansion through 2017. Beyond this time horizon, we assume a gradual slowing of both top-line growth and flattening operating margins as Zoetis' business matures.

We would also note that Zoetis is one of only three companies in our coverage universe (AGN and PRGO being the other two) where we assume a modestly positive terminal growth rate (2.5% for Zoetis). This is due to the macro drivers supporting volume growth for the company's products as well as the lack of true generic competition in the animal health space. Beyond the 2.5% terminal growth rate, other key assumptions in our DCF include a 9% WACC (consistent with the rest of our coverage universe).

Table 1: Zoetis DCF

		% of Value		
PV of FCF 2013-2017	$3,934	17%	WACC:	9.0%
PV of FCF 2018-2028	$8,659	38%	Terminal FCF Growth:	2.5%
PV of Terminal FCF	$10,367	45%		
Total PV of FCF	$22,961	100%		
Less: BV of Debt	$3,361			
Equity Value	$19,600			
Shares Outstanding	505			
DCF Share Price	**$39**			

Source: J.P. Morgan estimates.

No Perfect Comps but We See Several Names with Comparable Growth or End Market Characteristics…

From a comparable standpoint, Zoetis is the only large, publically traded animal health company and there is no single perfect comp group for the name. However, we looked across the healthcare sector (and beyond) for companies that had other similarities to the profile we see with Zoetis. This included durable, non-patent cliff exposed franchises, cash-pay businesses, and similar long-term macro drivers in a growing middle class globally. Along these lines, we see Allergan, Perrigo, Monsanto, and Mead Johnson (latest major pharma spin) as the best available group of valuation comparables. This group trades at 22x and 20x 2013 and 2014 EPS respectively as compared to Zoetis at 24x and 21x.

We would note that even these "comparables" have differences compared to Zoetis. Most do not have the leverage that Zoetis has post its IPO, most are less diversified, and some offer modestly faster or slower growth. That said, we believe they have enough similarities to be useful in benchmarking valuation for Zoetis. Importantly, we also see several potential sources of upside to our Zoetis forecasts over the next several years that would cause Zoetis' valuation to move more in line with this peer group.

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Table 2: Zoetis Comp Sheet

		Fundamentals								P/E Analysis			
		Price	Market Cap	Net Debt	EV	EPS (local)				P/E Ratio (local ratio)			
Company	Symbol	(local)	(mln USD)	(mln USD)	(mln USD)	2012	2013E	2014E	2015E	2012	2013E	2014E	2015E
Zoetis	ZTS	33.89	16,945	3,361	20,306	n/a	1.40	1.60	1.79	n/a	24.3x	21.2x	18.9x
Allergan	AGN	109.88	32,709	(1,401)	31,308	4.14	4.79	5.44	6.21	26.5x	22.9x	20.2x	17.7x
Perrigo	PRGO	116.29	10,878	767	11,645	5.32	6.18	6.95	7.48	21.9x	18.8x	16.7x	15.5x
Idexx	IDXX	91.55	4,997	(9)	4,987	3.13	3.53	3.90		29.2x	25.9x	23.5x	
Monsanto	MON	103.61	55,516	(1,511)	54,005	3.70	4.75	5.10	6.00	28.0x	21.8x	20.3x	17.3x
Mead Johnson	MJN	71.74	14,565	668	15,233	3.08	3.21	3.60	4.33	23.3x	22.4x	19.9x	16.6x
Virbac	VIRP FP	166.00	1,829	91	1,919	7.87	8.81	9.74	10.40	21.1x	18.8x	17.0x	16.0x
Vetoquinol	VETO FP	24.99	387	(34)	353	1.91	2.03	2.18	2.35	13.1x	12.3x	11.5x	10.6x
AVG (AGN, PRGO, MON, MJN)										26.4x	21.9x	19.9x	17.1x

		Enterprise Value							
		EBITDA (mln USD)				EV/EBITDA (USD ratio)			
Company	Symbol	2012	2013E	2014E	2015E	2012	2013E	2014E	2015E
Zoetis	ZTS	1,100	1,233	1,370	1,514	18.5x	16.5x	14.8x	13.4x
Allergan	AGN	1,987	2,192	2,462	2,721	15.8x	14.3x	12.7x	11.5x
Perrigo	PRGO	864	1,036	1,129	1,187	13.5x	11.2x	10.3x	9.8x
Idexx	IDXX	315	336	371	n/a	15.8x	14.9x	13.5x	
Monsanto	MON	3,787	4,395	4,602	5,304	14.3x	12.3x	11.7x	10.2x
Mead Johnson	MJN	983	1,009	1,101	1,363	15.5x	15.1x	13.8x	11.2x
Virbac	VIRP FP	154	194	209	251	12.4x	9.9x	9.2x	7.6x
Vetoquinol	VETO FP	55	59	63	n/a	6.4x	6.0x	5.6x	n/a

Source: Bloomberg, Company reports and J.P. Morgan estimates.
Note: MON is covered by JPM analyst Jeff Zekauskas and fiscal year end is August. MJN is covered by JPM analyst Ken Goldman

Zoetis' Valuation Is Highly Sensitive to Growth Sustainability and Peak Margin Assumptions

We looked at a number of variables that could impact Zoetis' valuation and see top-line growth and peak operating margin assumptions as the key focus for the story. Zoetis currently has operating margins in the low 20% range but we see a significant opportunity for these to improve. Currently, we forecast roughly 800 basis points of operating margin expansion through 2017 to the 30% range. However, greater than expected top-line growth or lower than anticipated expenses as Zoetis separates itself from Pfizer could translate to upside to this forecast.

Depending on where margins end up over time, as well as ultimate top-line growth, we see a range of valuation scenarios for Zoetis. Below, we compiled a matrix of DCF outcomes for Zoetis based on varying margin and growth assumptions.

Table 3: DCF Valuation Scenarios Based on Margins, Topline

		Topline Growth (2014-2023)				
		4.0%	5.0%	6.0%	7.0%	8.0%
Op Margin (2018+)	28.0%	$28.61	$31.22	$34.05	$37.10	$40.39
	30.0%	$30.72	$33.51	$36.53	$39.80	$43.33
	32.0%	$32.58	$35.55	$38.76	$42.23	$45.98
	34.0%	$34.48	$37.62	$41.03	$44.70	$48.68

Source: Company reports and J.P. Morgan estimates.

Scenario Assumptions

- **Margin Assumptions:** In all scenarios, we assume our current margin forecasts hold through 2017 and then shift to the margin levels in the matrix in 2018 and beyond.

- **Top-line Growth Assumptions:** For the top-line growth scenarios, we held 2013 sales fixed at our current forecast and grew them at the level in the matrix for 2014-2023, a ten year window.
- **Terminal Value:** For this analysis, we assumed a terminal growth rate of 3% and a WACC of 9% and calculated terminal value for years beyond 2023 (i.e., beyond our 10-year window).

Margin Expansion Represents a Key Piece of the Zoetis Story

Zoetis has generated fairly significant operating margin expansion over the past several years following the company's acquisitions of Wyeth's as well as King's animal health divisions. We expect this trend to continue over the next several years and see 2013 operating margins for Zoetis in the 24%-25% range. While this represents a meaningful improvement over the past several years, these margins are still below where we believe is achievable for a company with the scale of Zoetis.

For reference, Sanofi's animal health business, Merial, has operating margins in the 30% range. While Merial's product mix, which consists primarily of higher margin companion animal sales, may contribute to this margin performance, we would note that Zoetis' sales levels are roughly 50% above that of Merial in a business where scale should translate to higher margins.

Table 4: Merial Margin Structure, 2010-2012

% of sales	2010A	2011A	2012E
COGS	31.0%	32.2%	32.2%
R&D	7.8%	7.2%	7.5%
SG&A	30.5%	30.4%	30.7%
Operating Profit	31.3%	30.9%	30.9%

Source: Company reports and J.P. Morgan estimates.

In addition, Eli Lilly recently disclosed that margins for its Elanco division are in the mid-20's. We would note that the Elanco business is heavily skewed towards livestock and particularly feed additives and believe the Zoetis should be able to generate margins above that of Elanco over time given its much broader product portfolio.

Spin-Outs from Major Pharma Companies Have Historically Performed Well

While every asset is different, when we look to other spin-outs of non-pharma assets from major pharma companies, these companies have historically represented excellent investments. Of the spins over the past decade, pharma spins have outperformed the market by 50%, on average, in their first year. Already Zoetis shares have climbed 30% (vs. 4% for the S&P500) since trading began on Feb 1. Despite this initial outperformance, we continue to see upside in ZTS shares.

Figure 1: Historic Performance of Pharma Spins

New Company	Parent	Date of Spin	1 Yr Total Return	S&P 1 Yr Total Return	Outperformance
Mead Johnson	Bristol	2/11/2009	75%	32%	42%
Zimmer	Bristol	8/6/2001	34%	-27%	61%
Medco	Merck	8/20/2003	20%	12%	9%
Alcon	Nestle	3/21/2002	21%	-21%	42%
Hospira	Abbott	5/3/2004	21%	6%	15%
Guidant	Lilly	12/14/1994	157%	39%	118%
Average			54%	7%	48%

Source: Company reports and Bloomberg.

MJN could be a template for Zoetis share exchange

While Pfizer has not announced specific plans for its remaining 80% stake in Zoetis, we view the Mead Johnson split from Bristol-Myers Squibb in 2009 as a model for what could ultimately happen with Zoetis. *J.P. Morgan acted as a manager in the Zoetis initial public offering.*

Background on Mead Johnson

Similar to Zoetis, Bristol offered roughly a 20% stake in Mead Johnson through an IPO in February 2009. Subsequent to this offering, Bristol pursued the full split of Mead shortly after the mandatory 180 day period post-IPO via a share exchange which the company announced in November 2009.

As part of the exchange, BMY shareholders were able to exchange some, none, or all of their BMY stock for MJN stock at a discount. In the case of Mead Johnson, the exchange happened at a 10% discount to the average share price ratio over a set period of time. From a BMY standpoint, the BMY shares that were exchanged for MJN shares were cancelled, effectively reducing BMY's share count (and thus dividend payments).

The earliest Pfizer could pursue such a separation would be August 2013 and at current valuations, such as a share exchange would be roughly $0.08 accretive to Pfizer's annual earnings.

Figure 2: Potential PFE Accretion From ZTS Share Exchange
$ in millions

	Current	Post-Exchange
PFE 2014E Net Income Forecast	$16,407	$15,754
PFE 2014E Share Count	6,826	6,341
PFE 2014E EPS Forecast	$2.40	$2.48
	Accretion:	$0.08

Assumptions	
Current PFE Share Price	$27.94
Current ZTS Share Price	$33.82
Ratio: 1 share of PFE 0.83 shares of ZTS	0.83
Shares of ZTS to be exchanged	400
Number of PFE shares exchanged to cover all 400 ZTS shares	484
80% of ZTS 2014E Net Income	$653

Source: J.P. Morgan estimates.

Capital Deployment: A Variety of Options Beyond 2014

In the near term, we expect most of Zoetis' cash flow to go to one-time outlays supporting the separation from Pfizer, as well as to building a larger cash reserve for the company. However, looking out to 2015 and beyond when these expenses begin to fall away, we see Zoetis potentially generating over $1 billion in annual cash flow and see an opportunity for this cash flow to be redeployed through a mix of higher dividends, share repo, debt paydown, and business development. We would note that our current assumptions include modest levels of debt paydown, share repo and dividend increases but no business development. In addition our estimates, we have Zoetis building a cash balance of nearly $3 billion by 2017 and over $4 billion by 2020, which is clearly a very conservative assumption in our view.

Business Development: Acquisitions would likely be smaller

We see an interesting opportunity for Zoetis to augment its internal R&D efforts through the acquisition of product or pipeline portfolios and distribute these through the company's global selling infrastructure. In our view, a series of these acquisitions are far more likely than a larger acquisition by the company. Given the broad product portfolios of the larger animal health organizations, we believe the acquisition of a top 5 animal health company by Zoetis would be difficult to achieve. Further, we see the owners of these assets looking to grow, rather than sell, their animal health divisions.

Debt: Forecasting modest paydown but delevering largely driven by earnings growth.

Zoetis current leverage stands at roughly 3.0x 2013 EBTIDA and we anticipate this leverage to fall to 1.3x by 2017 based on roughly $1.25 billion debt paydown as well as operating income growth. That said, we anticipate the company will maintain some level of permanent debt due to its highly diversified and durable asset base and see debt paydown as a lower priority for the company.

Table 5: Debt Paydown Assumptions, 2013-2017E

$ in millions

	2013E	2014E	2015E	2016E	2017E
Debt beginning of year	3,650	3,650	3,650	3,400	2,900
Debt paid	-	-	(250)	(500)	(500)
Debt ending the year	3,650	3,650	3,400	2,900	2,400

Source: J.P. Morgan estimates.

We see an increasing amount of cash flow returning to shareholders in dividends and repo

With steadily growing cash flow throughout our forecast window, we see Zoetis devoting an increasing amount of cash flow towards higher dividends and share repurchase over time. However, our model still has a substantial portion of Zoetis' cash flow simply building on the company's balance sheet.

Interestingly, applying all of Zoetis' excess FCF to share repo over the next five years could add 3 percentage points of growth to our 2013-2017 EPS CAGR, moving it from 12% up to 15%.

Table 6: Dividends and Share Repurchase Assumptions, 2013-2020E

	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Dividends paid	$131	$143	$155	$177	$200	$216	$237	$258
Share repurchased	$0	$0	$0	$0	$0	$250	$350	$500
Return to shareholders	$131	$143	$155	$177	$200	$466	$587	$758

Source: J.P. Morgan estimates.

Risks to Zoetis and the Industry

Antibiotics Restrictions Represents a Key Risk

Zoetis is the leading producer of anti-infectives for animal use with an estimated 40%+ share of the overall market. However, there are growing efforts to reduce the use of these products in several markets including Europe and the United States. This is particularly the case with the prophylactic use of antibiotics in livestock. As a result, we are anticipating below market average growth for this segment of the animal health market over the next five years (low single digits relative to the mid-single digit growth for the industry).

Background on rationale for increased regulation

By way of background, in animal health antibiotics are not only used to treat disease but also to prevent the spread of infection as well as to promote animal growth and size. The regulation of antibiotic use in animals represents an effort to reduce drug resistance to these products. Just as physicians attempt to only prescribe antibiotics to humans when necessary, the FDA is looking to limit the use of medically important antibiotics in food-producing animals. This is particularly the case with medicines used in both human and animal health

Table 7: Antimicrobial Usage

Species	Antimicrobials used in human treatments	Antimicrobials not used in human treatments
Poultry	21%	79%
Swine	95%	5%
Cattle	40%	60%
Total	55%	45%

Source: FDA, Union of Concerned Scientists Report

Regulatory Actions in Europe and the US

Europe is ahead of the US in terms of regulating the usage of antibiotics in animals, particularly for growth promotion. After initially banning avoparcin for growth promotion in 1997, in 1999, the EU commission banned the usage of certain additional antibiotics for growth promotion and in 2006 banned all remaining antibiotic usage for this purpose.

In the US, in April 2012 the FDA issued guidance for the animal health industry calling for a voluntary phase-out of the use of certain antibiotics for production purposes (to increase animal growth and feed efficiency) and limiting the use of medically important antibiotics to situations considered necessary for assuring animal health. While these regulations are not yet mandatory, they represent an initial effort to restrict use of these products.

Roughly 30% of Zoetis' sales are antibiotics.

In 2011, Zoetis sales of antibiotics for livestock totaled $1.2 billion, or 28% of the company's overall revenues. These sales range from anti-infectives to medicinal feed additives. Importantly however, we estimate only a portion of these sales are into livestock in either the US or Europe for non-acute purposes. For example, we do not expect near-term regulation of ex-US or Europe antibiotic usage or for use of antibiotics for acute illness and in companion animals in either the US or Europe. That said, this will clearly be a topic to watch going forward as the regulatory environment evolves over the coming years.

Generic Noise in US Companion Business, Expecting Limited Impact

Currently, generics have a limited presence in the animal health market and are largely promoted as "value brands" by other large industry manufacturers as compared to the directly substitutable business seen in US human pharma. As a result, despite the fact that 80% of Zoetis' products are off-patent, the company continues to generate over $4bn in annual sales (and growing) with multiple examples of products with sales that continue to grow post patent expiration. Incidentally, we would note that Zoetis is also the largest producer of generic animal health products following its acquisition of Ranbaxy's Vetnex animal health franchise in 2009.

One of the primary reasons for limited generics impact within animal health space is the lack of a generic infrastructure to sell to livestock producers and vets. We see Zoetis' direct distribution model and relationships with farms in the livestock business and vets on the companion business as a particularly high barriers for generics to overcome, as evidenced by sales of generic animal health businesses by several large generic manufacturers over the past five years (ie Ranbaxy to Pfizer, Teva to Bayer).

Potential changes in companion animal prescribing in the US

The FTC is examining the current structure of companion animal prescribing that makes it difficult for generics to gain inroads into the market and hosted a workshop on the topic in October 2012. We will continue to watch for any push to change the current industry dynamics.

If changes do occur, we would envision something along the lines of the proposed Fairness to Pet Owners Act of 2011 (H.R.1406). This bill would require vets to provide pet owners with a copy of their pets' prescription and a written disclosure that the pet owner may fill the prescription through either the vet or (if available) another pharmacy of their choice. This would prohibit vets from setting conditions around pet prescriptions such as requiring owners to fill their prescriptions with the vet.

We expect vets to be opposed to such as measure (as they were in the FTC's October workshop) given the significant markup charged for these medicines they prescribe. In fact, the profits derived from prescribing medications can account for a meaningful percentage of profits in a typical vet practice.

Potential impact from wider availability of companion animal prescriptions

Because many animal health manufacturers sell directly to vets, traditional pharmacies do not typically stock animal health products and there are limited alternatives in terms of where a pet owner could fill a script aside from the vet's office or limited internet providers.

However, it is possible that if providing scripts were required nationally, pharmacies may be incentivized to stock animal health medicines and generic animal health manufacturers could much more easily establish relationships to supply pharmacy chains. This could in theory lead to increased generic competition in the companion business.

Importantly, we would note that we would not see these changes having a dramatic impact to the company's US companion business. We estimate that sales of US medicines for dogs and cats account for approximately 15% of Zoetis' overall revenues. Further with a large portion of Zoetis' US companion business either branded or injectable products, we see the actual percentage of Zoetis' business exposed to this trend as substantially smaller than this figure.

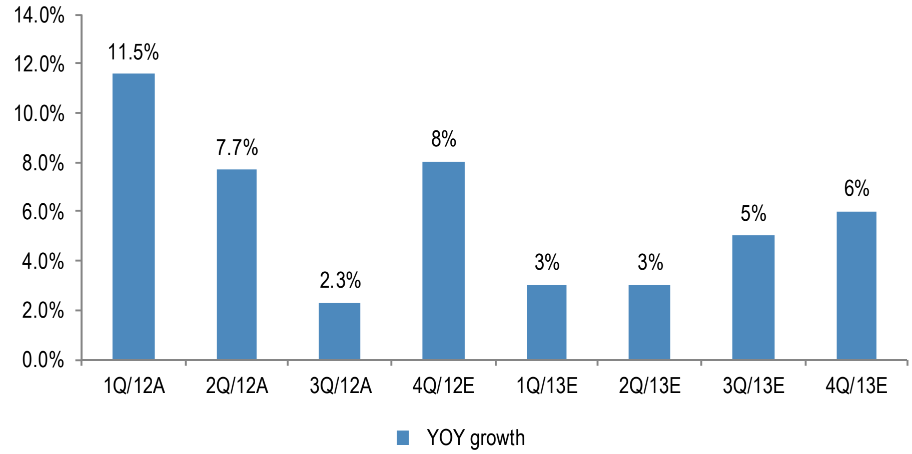
While we will clearly watch this risk as it relates to Zoetis, we see several barriers to generics even if this shift in prescription rules were to occur.

- **(1) Convenience.** We believe some pet owners will find it more convenient to pick up their pets' medicines when they are at the vet office already.
- **(2) Administration.** We believe the route of administration will be relevant here, particularly for injectable products, as we see pet owners likely to prefer their animals' shots be administered by a vet.

Watching Impact from US Drought; View as Manageable

Changes in weather conditions can reduce demand for Zoetis' livestock business. For example, the severe drought we have seen in the US over the past year has led to higher feed prices and producers reducing overall herd size in response. In 2012, we saw US growth decelerate from 12% in the first quarter to 8% in 2Q and 2% in 3Q. While ZTS has not yet reported 4Q, Pfizer's reported US animal health revenue grew 8% in 4Q. We will continue to watch this business for signs of a faster or slower recovery from the drought. We currently model 3% growth in the US business for the first half of 2013, improving to 5% in 3Q and 6% in 4Q/13.

Figure 3: US Growth Forecasts, 1Q/12-4Q/13E



Source: Company reports and J.P. Morgan estimates.

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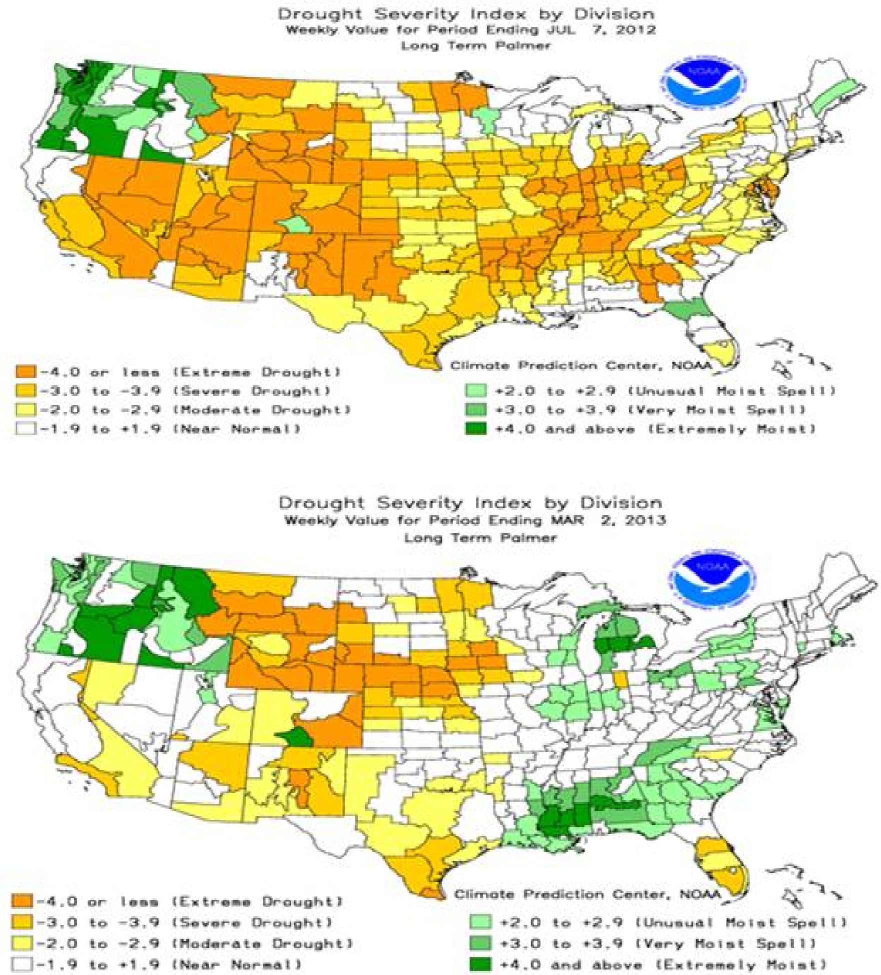
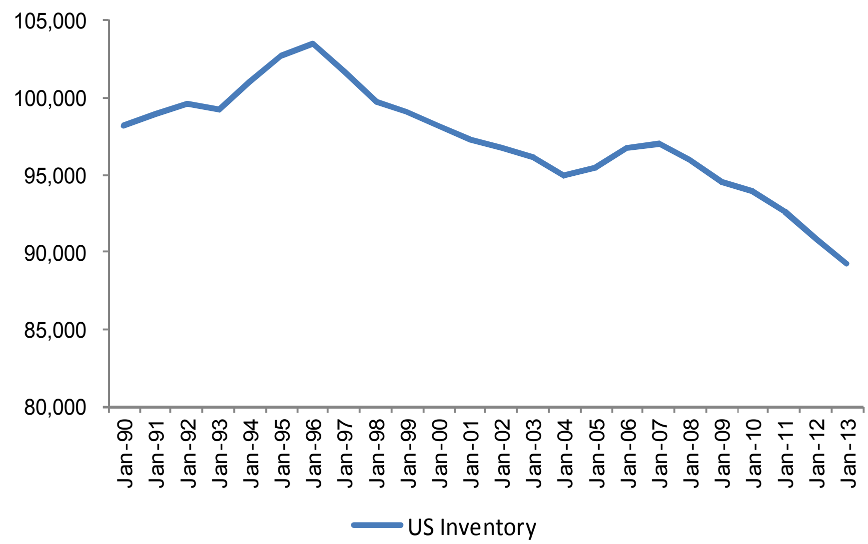
Figure 4: US Drought Severity, July 2012 (above) and March 2013 (below)



Source: Climate Prediction Center, Palmer Drought Severity Index

Figure 5: US cattle inventory
Thousand of head



Source: USDA cattle reports

Zoetis Must Separate Its Operations from Pfizer

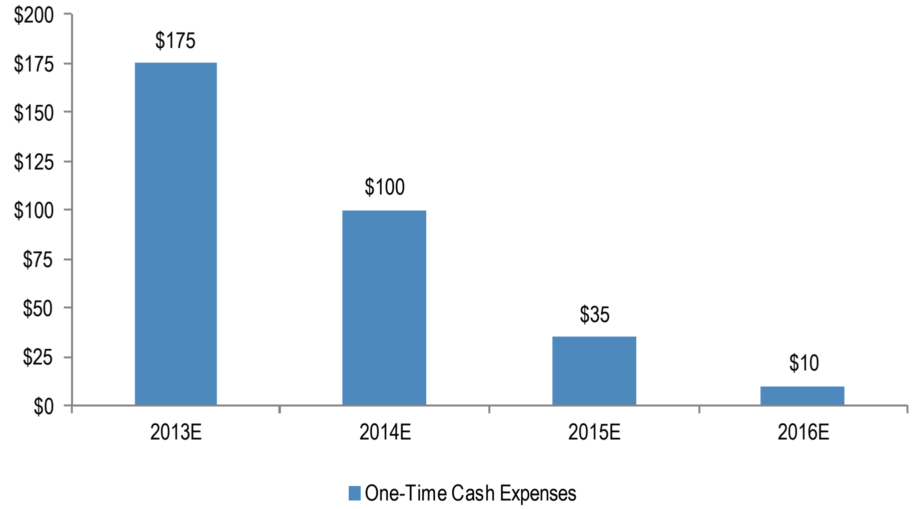
Much of Zoetis' operations are distinct from Pfizer, including functions such as sales and marketing as well as R&D. However, the company will need to build its own infrastructure in several areas (particularly back office) over the next several years.

We see one-time charges impacting near-term cash flow

In particular, we see a step-up in one-time expenses in 2013 and 2014 for Zoetis as the company builds out its business technology infrastructure. As one-time items, we do not model these costs running through our non-GAAP P&L. However, these expenses will have an impact on near-term cash flows. We see this separation process, and the cost associated with it, largely complete by 2015 and forecast $175mm of one-time cash expenses in 2013, dropping to $100mm in 2014 and $35 mm in 2015.

Figure 6: Estimated One-Time Cash Expenses

$ in millions



Source: J.P. Morgan estimates.

Zoetis expenses could be below those allocated by Pfizer

Zoetis operating expenses will include costs allocated by Pfizer for the support services provided as Zoetis builds out its infrastructure. We believe Zoetis' own infrastructure, once completed, may be able to operate at a lower cost than those being allocated to the company. Along these lines, we see an opportunity for Zoetis to further improve its operating margins beyond 2015 in areas such as G&A.

Manufacturing costs could step up in 2015 and slow gross margin expansion

We estimate that roughly one-third of Zoetis' current manufacturing is occurring at facilities that will remain part of Pfizer after the separation. While Zoetis will be provided these products at cost through 2015, the company will face a 15% step-up in cost associated with product remaining at these facilities after that time. We estimate that this step up could represent a roughly $0.10 headwind to 2015 EPS. However, we expect Zoetis to move a portion of these products to wholly owned manufacturing plants or to other less expensive vendors prior to the step-up on Pfizer-made products. Along these lines, we are forecasting a fairly minimal impact to 2015 earnings from this increase in Pfizer production costs.

Table 8: Impact of Leaving All Current PFE Manufacturing with Pfizer Longer-Term

$ in millions

	2015E
COGS	$1,733
Value manufactured by PFE (estimate 1/3 of total)	$578
15% mark-up on PFE production	$87
Gross margin impact	173 bps
EPS impact	-$0.12

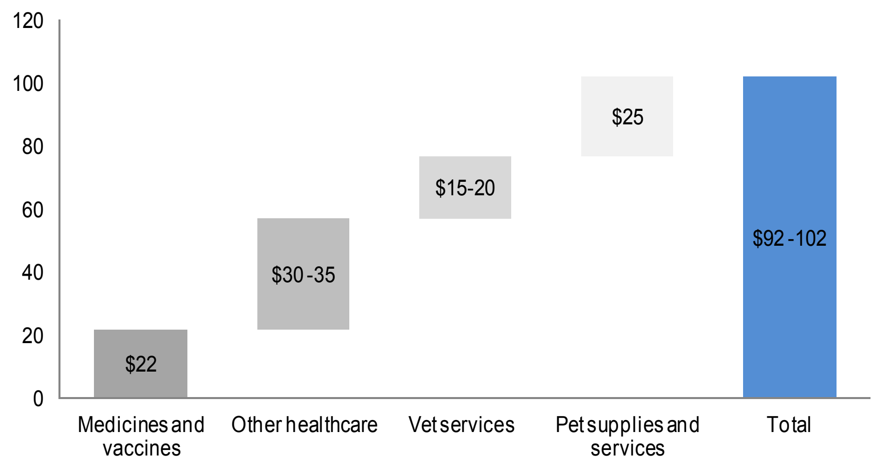
Source: J.P. Morgan estimates.

Industry Dynamics

With roughly 7% annual growth over the past five years and mid-single digit annual growth expected over the next several years, we see the animal health market as an attractive investment opportunity. Favorable macro trends such as the growth of a global middle class which consumes higher amounts of meat-based protein and dairy as well as higher pet ownership and pet spending support this continued growth. In addition, animal health products represent a small piece (2-3%) of a farm's expenses but have a large impact on investments producers make in their herd, creating a strong rationale for their use.

The segment of the animal health industry Zoetis competes in consists of animal medicines, vaccines, medicinal feed additives, and paraciticides and is estimated at over a $20 billion category.

Figure 7: Global 2011 Animal Health Revenues
$ In billions



Source: Vetnosis

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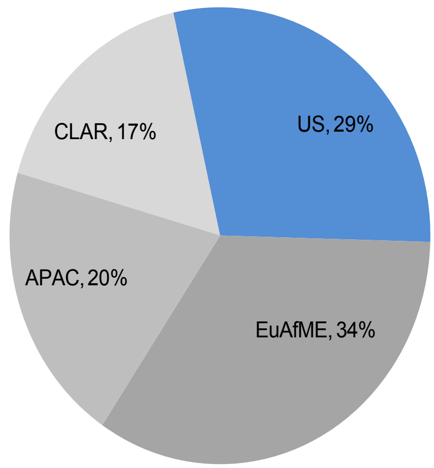
Figure 8: Animal Health Industry 2011 Revenue By Region



Source: Vetnosis

The Animal Health Industry Has Some Notable Advantages over Traditional Pharma

There are several key differences that in our view make the animal health industry distinct from traditional human pharma. In particular, we believe the following characteristics of animal health compare favorably with human pharma: (1) lack of an established generics industry/infrastructure, (2) limited government or third party payer exposure, and (3) shorter, less expensive and less risky R&D cycles. These factors should translate to a highly sustainable growth profile for the animal health industry as compared to patent expiration cycle impacted human pharmaceutical model.

Table 9: Key Differences Between Animal Health and Traditional Pharma

Animal Health	Human Pharma
Cash pay, no third-party payers	Third-party payers dominate (gov't and insurance/PBMs)
Limited generic competition	Aggressive generic competition
Shorter, less risky R&D cycles	Long, expensive R&D cycle

Source: J.P. Morgan

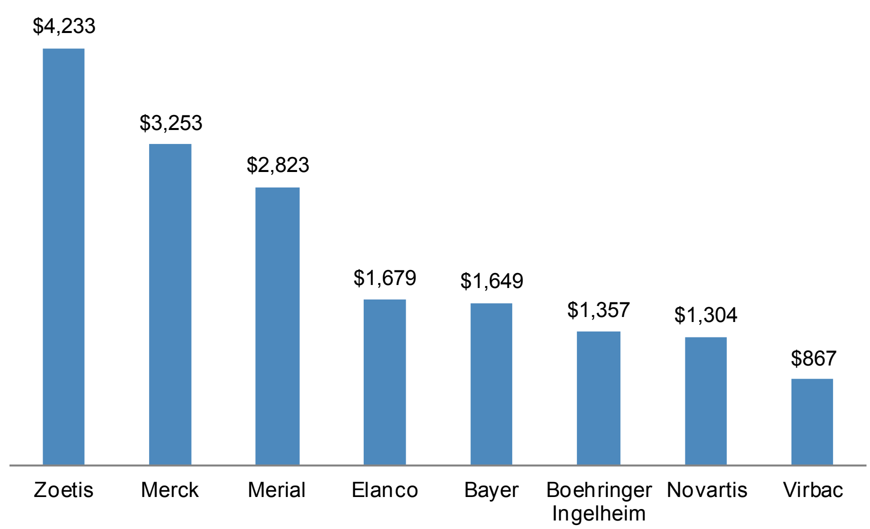
- **Lack of an established generics industry/infrastructure.** Currently, generics have a limited presence in the animal health market and are largely promoted as "value brands" by large branded manufacturers as compared to directly substitutable business US human pharma model. One of the primary reasons for limited generics impact within animal health space is the lack of a generic infrastructure to sell to farmers and vets. We see Zoetis' direct distribution model and relationships with farms in the livestock business and vets on the companion business as particularly high barrier for generics to overcome, as evidenced by sales of generic animal health businesses by several large generic manufacturers over the past five years (e.g., Ranbaxy to Pfizer, Teva to Bayer).

- **Limited government or third party payer exposure.** Animal health products, whether sold to livestock producers or to pet owners for their pets, are typically cash pay businesses and not subject to government or third-party payer influence. This keeps the decision making power with the farmer/pet owner and is in contrast to human pharma where third-party payers have leverage to push patients towards certain products and away from others based on coverage and co-pay tiering.
- **Shorter, less expensive and less risky R&D cycles.** The research and development cycle in animal health is much shorter and less expensive than in human pharma. For one, clinical research can begin straight in the target species (vs. the pre-clinical process for human drugs) and in addition, animals have shorter lifecycles than humans, so studies can generate useful data more quickly. Finally, much of the R&D work in animal health revolves around line extensions and lifecycle management (i.e., slight improvements to existing products), which inherently take less time and are less costly.

The Animal Health Industry Is Largely Captive Within Major Pharma Organizations

Seven of the ten largest animal health companies are divisions within traditional pharmaceutical companies. Along these lines, Zoetis is somewhat unique in being standalone, particularly in the context of other non-captive animal health companies being significantly smaller than Zoetis.

Figure 9: Animal Health Industry 2011 Revenue For Top 8 Companies
$ In millions



Source: Vetnosis

Limited Competitive Intensity Within Product Categories

While there are 10 major players in the animal health market, the mix of their businesses varies fairly significantly. In fact, Zoetis is one of two organizations (Merck Animal Health being the other) offering a highly diversified product portfolio with presence in almost all major product categories. Other players have significant presence in a particular area (e.g., Elanco in feed additives, Sanofi in parasiticides) but not the large product breath of Zoetis. We believe Zoetis' broader product offering will enable the company to gain share with its customers over time.

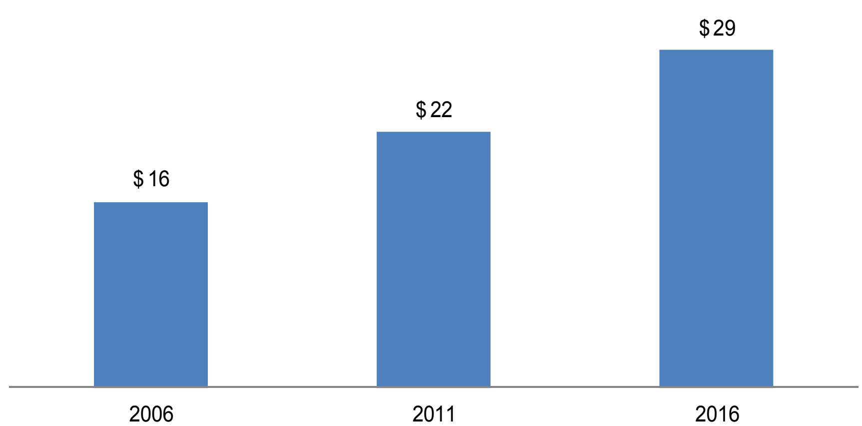
When looked at it from a product category perspective, we see the animal health business as effectively an oligopoly with the top three players in any major product category generally holding over 60% market share. We believe this industry dynamic supports sustainable modest price increases despite the lack of formal patent protection of many of the products sold across the space.

Table 10: Sources of Top-line Growth

	Sources of Revenue Growth
Volume	2%
Price	2%
New Products	1%-2%
Overall	5%-6%

Source: J.P. Morgan estimates.

Figure 10: Global Medicines and Vaccines Revenues
$ In billions



Source: Vetnosis.

Zoetis: Overview

Company History

Zoetis began as the animal health business within Pfizer, originally known as the Agriculture Division, in 1952. The segment developed its own R&D unit in the 1970s and eventually was renamed Pfizer Animal Health Division. Over the years based on organic growth and through a series of acquisitions, most recently Wyeth's Fort Dodge business and King's animal health unit, Zoetis grew into a $4+ billion diversified global business. The company currently holds a clear leadership position in the industry with #1 share in almost all geographies and a top three position in all product categories.

Table 11: Market Position By Geography

North America	# 1
Latin America	# 1
Europe	# 2
Asia	# 1

Source: Industry sources

Table 12: Market Position By Species

Companion Animal	# 2
Cattle	# 1
Swine	# 1
Poultry	# 2

Source: Industry sources

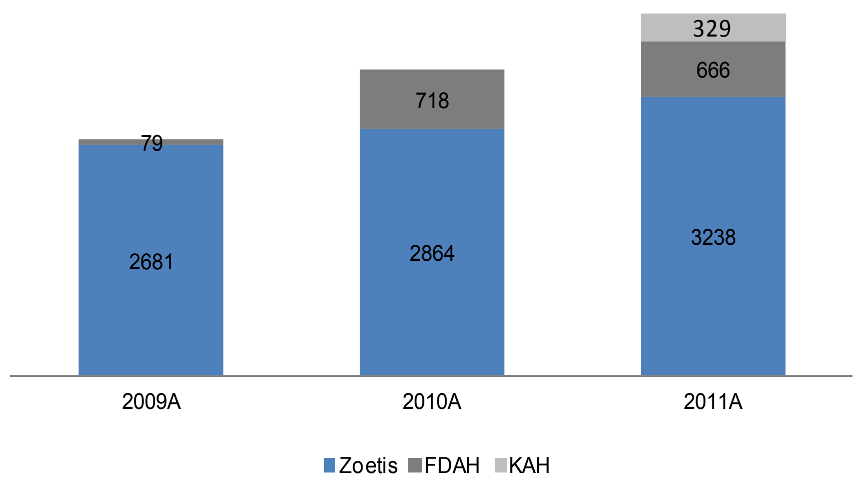
Acquisitions Have Been a Key Piece of the Zoetis Story

While the base Zoetis business has grown organically over the years, a series of acquisitions have played a key role in giving the company the size and scale it has today. Most notably, Pfizer's acquisition of Wyeth brought with it the Fort Dodge animal health business which added roughly $700 million of sales to Zoetis. Then, in 2011, the King acquisition added $300 million in animal health revenue.

While the integration of Fort Dodge and King appears largely complete, we see further opportunity for Zoetis to fully exploit its expanded product offering from a sales perspective and to continue to optimize its manufacturing and expense structure.

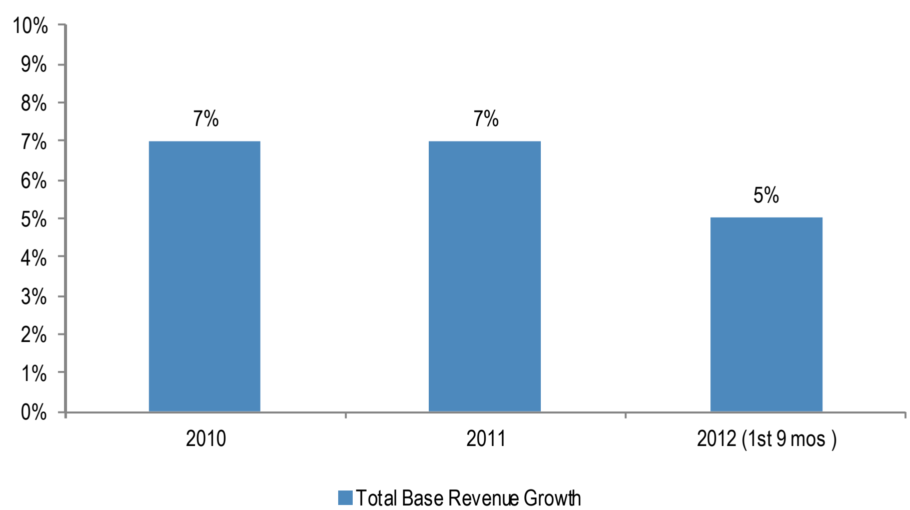
Going forward, we expect M&A to be a smaller piece of the growth story for Zoetis. As the market leader, we believe it will be difficult for Zoetis to pursue any large acquisition from an antitrust standpoint. In addition, with a leading presence in nearly all geographies, there is less rationale for Zoetis to pursue large-scale M&A in our view. That said, we expect Zoetis to pursue smaller bolt-on acquisitions going forward, both in the company’s core product categories as well as in adjacent businesses such as diagnostics, based on our conversations with management.

Figure 11: Revenue
$ millions



Source: Zoetis

Figure 12: Base Revenue Growth By Region (Constant Currency, Excludes M&A)



Source: Company reports and J.P. Morgan estimates.

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Table 13: Base Revenue Growth (Constant Currency, Excludes M&A)

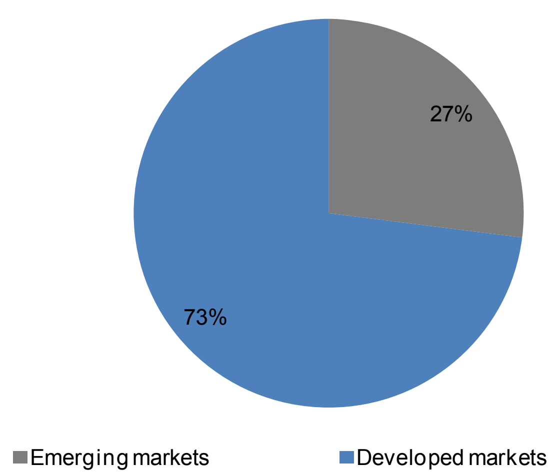
	Base Revenue Growth		
	2010	2011	2012 (9 mos)
Total revenues	**7%**	**7%**	**5%**
US	13%	7%	6%
EuAfME	-1%	3%	0%
CLAR	5%	9%	4%
APAC	15%	12%	8%

Source: Company reports and J.P. Morgan estimates.

Significant Emerging Markets Presence

Zoetis has the largest emerging markets presence of any name in our coverage universe with nearly 30% of sales coming from these geographies. We anticipate low double digit growth for the company's emerging market franchise over the next several years based on continued favorable demographics in these territories, which offer both a combination of high population growth as well as raising levels of meat and dairy consumption. In particular, China and India each represented less than $100 million of 2011 sales for Zoetis as gaining access to these markets has been difficult. However with industry scale farms emerging, particularly in China, we anticipate rapid growth from these markets going forward.

Figure 13: Revenue by region for 2011



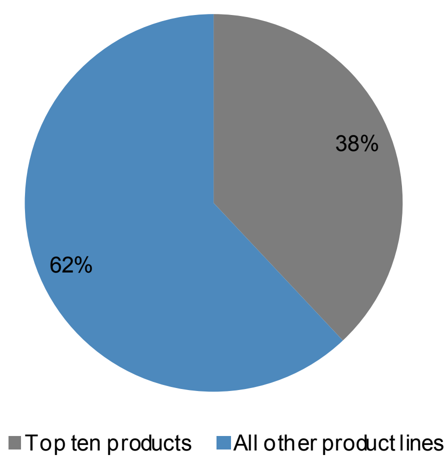
Source: Zoetis

Diversified Sales Mix: By Geography, Category, Species and Product

Zoetis' revenue mix is highly diversified, whether looked at by product, category, or geography. The company has a broad geographic footprint with 60% of sales generated outside the US and 27% of sales generated in emerging markets, which is the highest level of any name in our coverage universe.

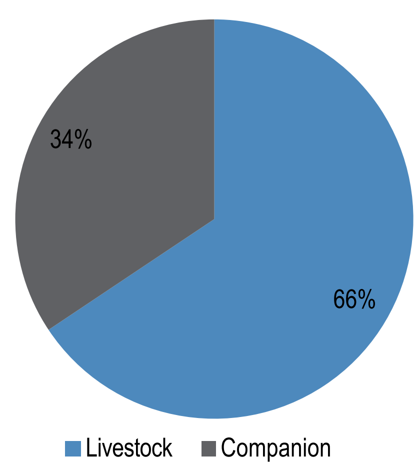
In addition, Zoetis is diversified from a product, category, and species standpoint with its largest product representing only 8% of sales and its top ten products contributing less than 40% of sales.

Figure 14: Revenue by product line for 2011



Source: Zoetis

Figure 15: Companion vs. Livestock Breakdown, 2011



Source: Zoetis

Zoetis' sales mix is also diversified when looked at by product category, limiting the exposure to any one group of animal health medicines. There is also a healthy

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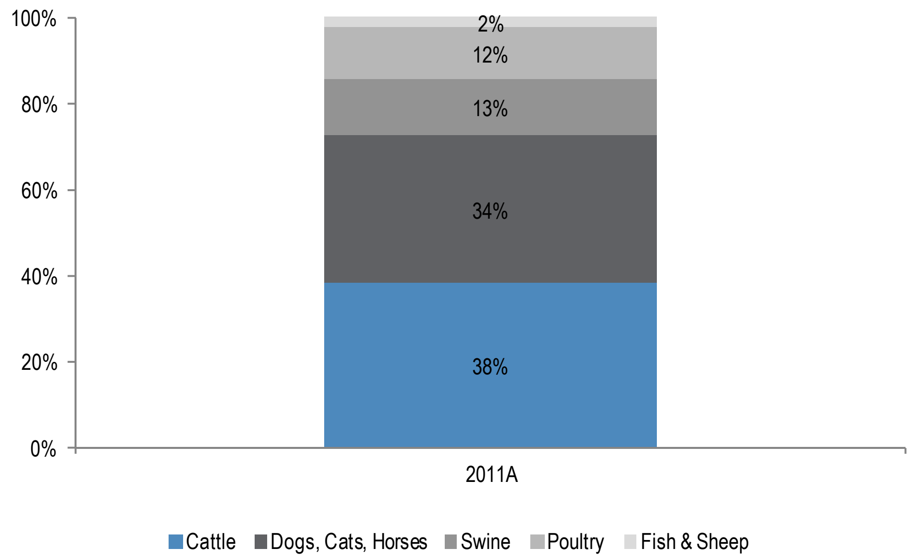
balance across species with roughly two-thirds of sales driven by livestock and one-third coming from companion animals. Relative to the industry, Zoetis' mix is slightly more skewed towards livestock and cattle in particular.

Figure 16: Revenue By Species In 2011



Source: Zoetis.

United States: Zoetis' Largest Region

The US represents Zoetis' largest region, accounting for roughly 40% of the company's sales. Not surprisingly, as a developed market, Zoetis' US business is slightly more skewed towards companion animals (40% of US sales) relative to its overall mix (34% companion overall). Nonetheless, Zoetis' livestock business remains the largest piece of the US business with cattle as a particularly important species in this region.

In 2012, the growth of the US business slowed due to the major drought the country experienced. Feed prices were driven higher and as a result farmers culled cattle herds and delayed the movement of cattle from the pasture to feedlots, which reduced the demand for Zoetis' products. We will watch for residual effects from the drought in 2013 and are forecasting continued depressed growth rates in the US during the first half of the year. However, following healthy 4Q/12 US animal health results reported by Pfizer (which have historically tracked fairly closely with Zoetis), we believe our estimates for Zoetis' US franchise may be conservative this year.

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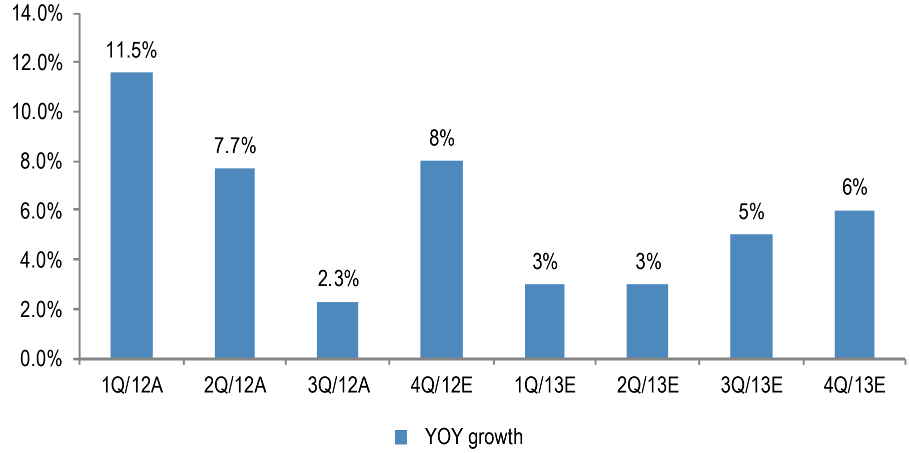
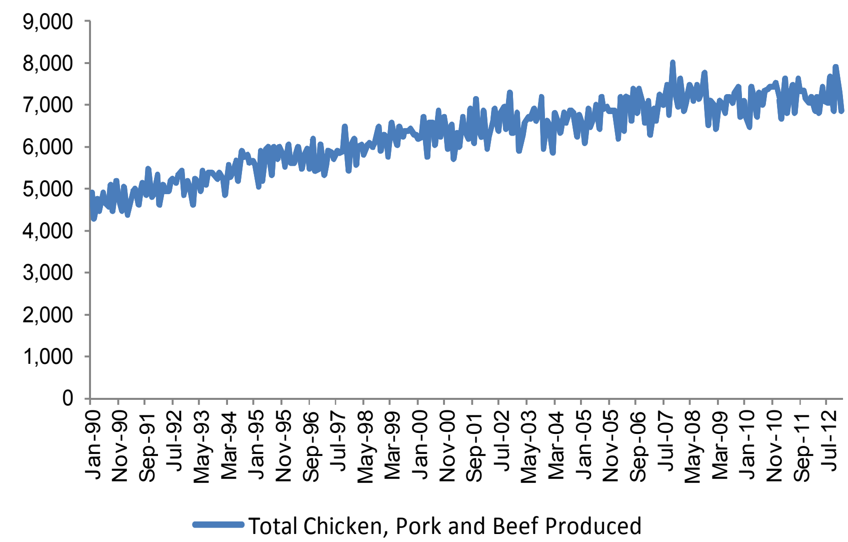
Figure 17: US Growth Forecasts, 1Q/12-4Q/13E



Source: Company reports and J.P. Morgan estimates.

Longer-term, we expect healthy growth of 5%-6% for the US animal health business over the next several years driven by a mix of companion and livestock.

Figure 18: Total Chicken, Pork and Beef Produced in US
Millions of pounds



Source: USDA and JP Morgan

Europe: Growth Challenges but Still a Major Opportunity

Zoetis reports sales from Europe, Africa, and the Middle East as a single segment referred to as the EuAfME region. This is the company's second largest geography, accounting for approximately 25% of sales. In addition, while the region consists of a number of countries, we would note that the big five countries in Europe (UK, France, Germany, Italy, Spain) account for roughly 65% of this region's sales, with only 17% of the segment's sales coming from outside of Europe overall. From a species standpoint, this region is again skewed towards cattle (~40% of sales) with a below-average contribution from companion animals (~30%).

The EuAFME segment is the company's slowest growing as a result of the economic challenges currently facing Europe as well as ongoing legislation to restrict antibiotic usage. However, there is a substantial opportunity in the emerging markets component of this business with a fast-growing livestock market and an emerging middle class. Taking these factors together, we forecast 3% longer-term growth for this segment, which is below that of Zoetis as a whole.

Asia Pacific: Significant Growth Opportunity

We expect Zoetis' Asia-Pacific (APAC) region will be its fastest-growing segment and model 8%-10% growth for this geography over the next several years. Today, the APAC region is the company's smallest, accounting for roughly 16% of sales with equal weighting of more developed markets and emerging markets. Australia/New Zealand make up roughly 35% of this segment with Japan accounting for another 20%. Relative to the company's overall species mix, the APAC region is much more exposed to poultry (~18%) and swine (~22%) with a relatively lower exposure to cattle (24%).

Interestingly, China and India make up less than 20% of regional sales (and roughly 3% of overall company sales). From an absolute dollar perspective, Zoetis is generating less than $100 million of annual sales in each of these very large countries. While it may take Zoetis several years to gain significant traction (for China in particular), we see a very substantial opportunity for growth in these markets based on population size, growth, and the rapidly growing middle class in these markets.

Canada/Latin America: Another High Growth Region

The Canada/Latin America (CLAR) segment accounts for roughly 18% of Zoetis' sales and we expect this unit to be the second-fastest growing of the company's four main geographies. Brazil, a major cattle producer, is by far the largest country in this segment, making up nearly half of the region's sales with Canada representing roughly 25% of sales in the region. The CLAR segment is heavily skewed towards cattle (roughly 50% of sales) with a relatively low percentage of sales coming from companion (~20%).

Once again, we see the population growth and growing middle class in Latin America as driving increased demand for meat protein and pet ownership. In addition, as an exporter of protein, increasing global protein demand will also contribute to growth in this region.

Direct Sales Network and Global Reach

Over the past several years as the company's sales and portfolio grew, Zoetis developed a global direct sales network to gain better access to its customers. We believe this direct sales model allows Zoetis to quickly react to evolving customer needs, better protect its franchise and makes the company less reliant on third-party distributors. Overall, we see Zoetis' direct sales network as a significant competitive advantage for the company and believe this infrastructure will allow the company to grow its business at least in line with the industry and achieve above average operating margins over time. The company has the largest field force (~3500 reps) and a direct sales presence in 70 countries worldwide.

Diversified Manufacturing Network

Zoetis' manufacturing network consists of 29 sites (13 "anchor" and 16 satellite) in 11 countries around the world. The company also uses roughly 200 third-party contract manufacturers (CMOs) as well as existing Pfizer facilities to produce its products. This is with roughly one-third of the company's products produced at its own facilities, one-third via third-party arrangements, and one-third at legacy Pfizer plants. While Zoetis appears to be operating an unusually complex manufacturing infrastructure, the company sees value in having its manufacturing spread across its different geographies. Products such as feed additives are heavy and expensive to ship globally. In addition, countries have specific manufacturing requirements for certain products, necessitating specialized facilities.

That said, we expect Zoetis to transition more of its production to its own manufacturing sites over the next several years and to reduce its dependence on Pfizer for that part of its manufacturing. Along these lines, we are anticipating modest gross margin expansion for the company over the next 3-5 years as Zoetis further optimizes its manufacturing infrastructure.

Standalone R&D Infrastructure

Headquartered in Kalamazoo, Michigan, the Zoetis R&D unit has been run as a fully independent segment within Pfizer since 2003 and has satellite facilities globally. Unlike human pharmaceutical drug development, a majority of Zoetis' R&D projects are focused on product improvements as compared to higher risk novel drug development. Further, R&D cycle times for animal health products are significantly shorter relative to human development work. This is a result of several factors including the ability to immediately study drugs in the target species (eliminating pre-clinical testing), and the shorter trial duration given shorter animal lifespans relative to humans. Together, we view R&D as a far more attractive investment in the animal health space relative to the human market due to this combination of largely line extension R&D as well as short R&D timelines.

Zoetis has a proven track record with its R&D unit with the company accounting for 25% of FDA animal health approvals from 2004-2011 and 20% of all USDA animal vaccine approvals over that time frame.

Following the separation, Zoetis has access to Pfizer's library of compounds for seven years. In addition, Zoetis can now pursue relationships with other human pharmaceutical companies that might otherwise not have been willing to work with Pfizer.

Industry Drivers

The demand for animal health medicines and vaccines is driven by the number of animals, both pets and livestock, worldwide. Both are tied to the growth of the human population and its relative economic well-being. As the population grows, the demand for food (animal protein) naturally grows with it. In addition, there are

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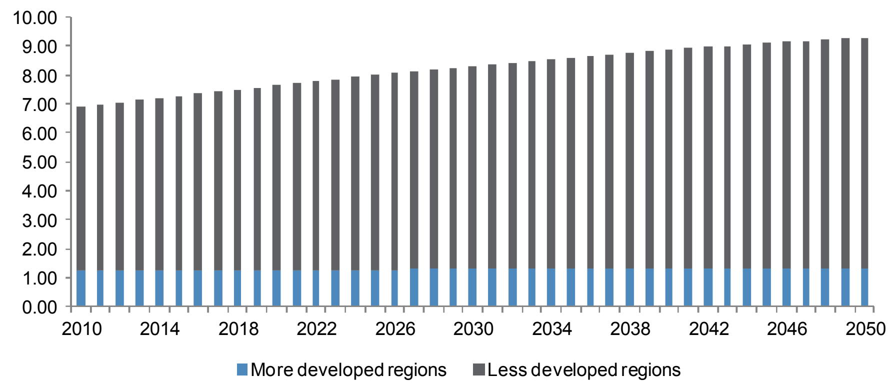
marked differences between protein and dairy consumption in the developed and the developing world. We believe this gap will begin to shrink as the developing markets become wealthier and better able to afford these products. We believe the same trend holds true for pet ownership and pet spending.

Population growth

Rising world population with increasing per capita consumption of meat and dairy products will aid the demand of healthy, disease free livestock in future years. A significant portion of population growth over the next 20 years will come from developing regions which are expected to grow at 1.1% CAGR through 2025 and thereafter moderate to 0.7% CAGR through 2050. Developed regions, on the other hand, are expected to have a more modest growth of 0.14% CAGR through 2050.

Figure 19: Population growth trends

In billions

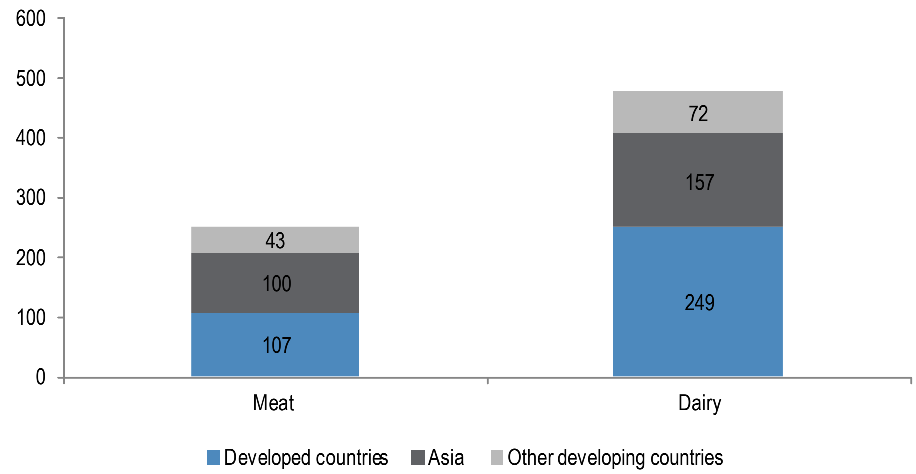


Source: United Nations World Population Prospects: The 2010 Revision population database

Notable Differences in Consumption Levels

There are meaningful differences in per capita consumption in developing regions as compared to the developed world with areas such as Latin America consuming roughly 50-75% as much meat and dairy as the developed world on a per capita basis and the rest of the developing world at close to 30% of developed country levels on a per capita basis.

Figure 20: 2003 Meat and Dairy Consumption, Developed Countries, Asia, and Developing
Million metric tons

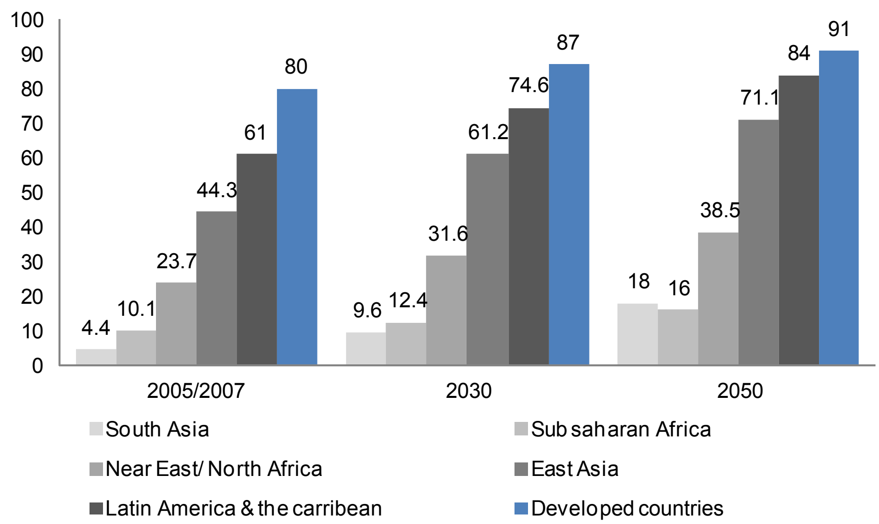


Source: Zoetis, United Nations World Population Prospects: The 2008 Revision Population Database; USDA World Markets Livestock and Poultry; Census Bureau Int Meat Consumption; FAO The state of Food and Agriculture Report

Meat and Dairy Consumption – Emerging Markets Expected To Close Gap Relative to Developed Markets

Meat and dairy consumption in developing markets lags that of developed markets on a per capita basis. This gap is expected to close over the next several decades as developing nations become wealthier and their populations are able to afford more protein and dairy in the diet. Coupled with higher population growth, we are anticipating significant Zoetis/animal health growth in the emerging markets over the next 10+ years.

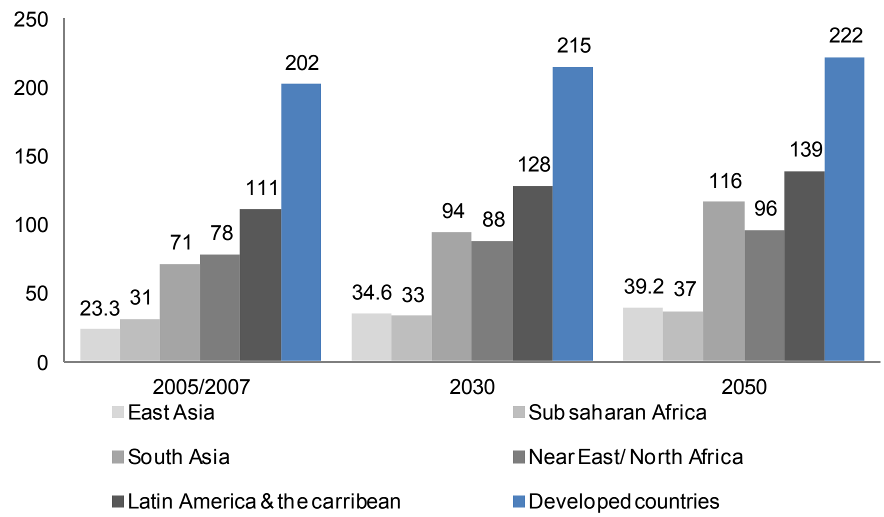
Figure 21: Meat consumption
Kg/person/year



Source: World agriculture towards 2030/2050, The 2012 revision. Food and Agriculture Organization of the United Nations

Figure 22: Milk & Dairy Consumption

Kg/person/year



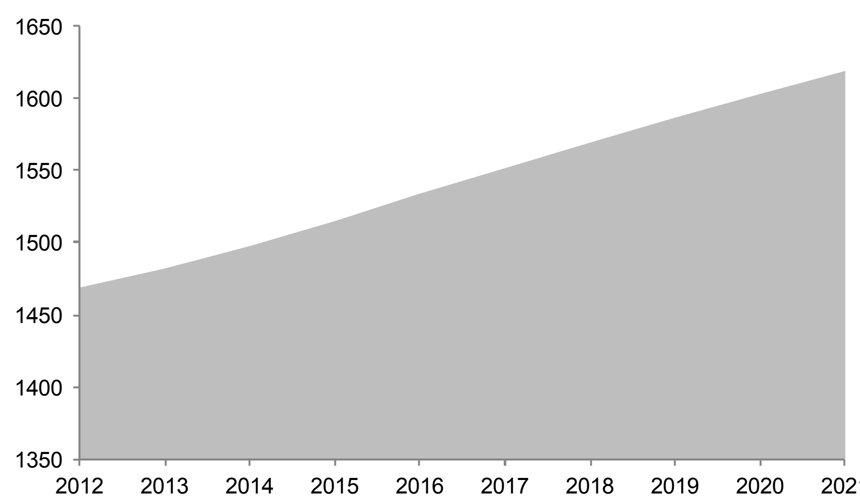
Source:World agriculture towards 2030/2050, The 2012 revision. Food and Agriculture Organization of the United Nations

Continued Livestock Herd Growth Predicted

Together, the trends discussed above suggest continued growth in global livestock herds for the foreseeable future and we believe support our growth expectations for Zoetis.

Figure 23: Global Cattle Inventory

Million heads



Source: FAPRI Outlook 2012 projections

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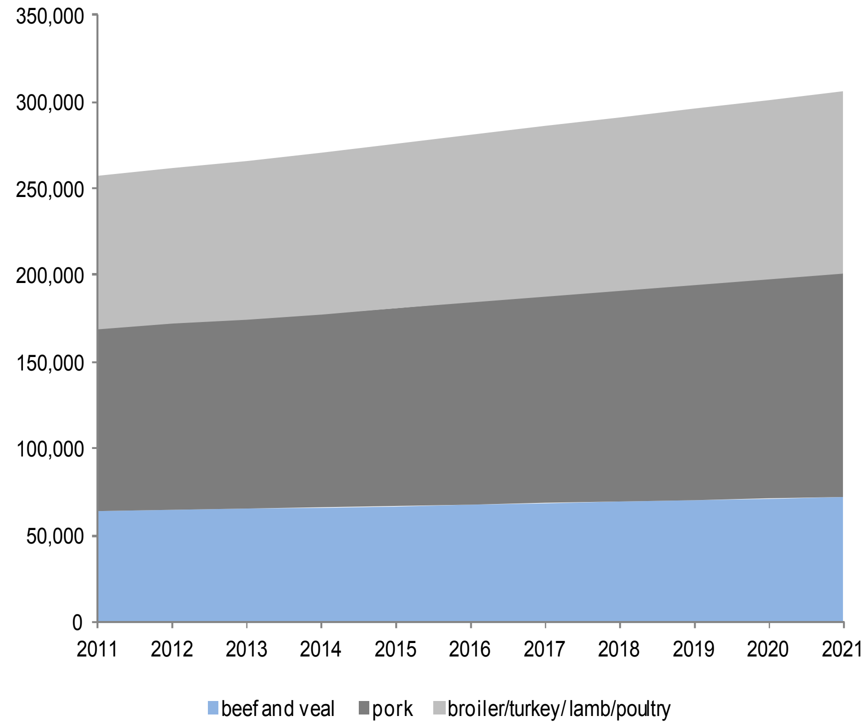
Figure 24: Global production
Thousand metric tons



Source: FAPRI Outlook 2012 livestock projections

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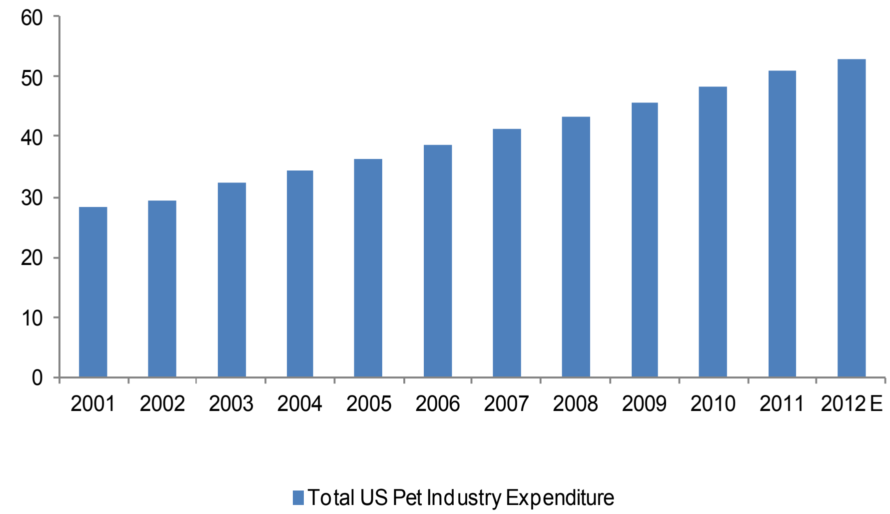
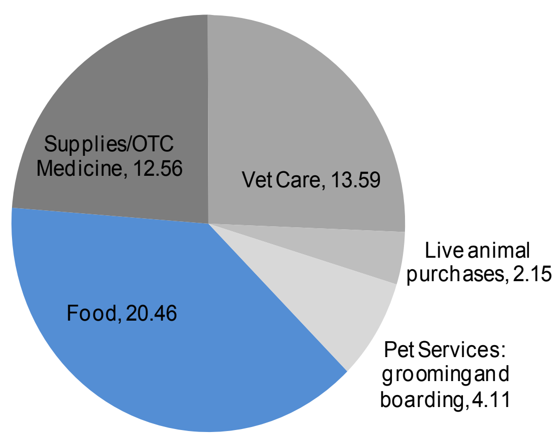
Companion animal market has similar growth opportunity

Figure 25: Total US pet industry expenditure: 6% CAGR over the past 10 years
$ In billions



Source: American Pet Product Association

Figure 26: 2012E Pet Industry sales breakdown
$ In billions



Source: American Pet Product Association

Management Discussion

Juan Ramón Alaix, CEO

Juan Ramón was appointed CEO at Zoetis in July 2012 and is also a member of the Zoetis Board of Directors. Prior to Zoetis, Mr. Ramón worked at Pfizer, where he joined in 2003 from Pharmacia, as regional president, Central/Southern Europe and rose to President of Pfizer Animal Health in 2006. In the past, he has also served in general management with Rhône-Poulenc Rorer in Spain and Belgium before becoming country president for Pharmacia in 1998. In 2011, He was elected to a two-year term as president of IFAH.

Richard A. Passov, CFO

Rick Passov was appointed EVP and CFO of Zoetis in July 2012. Prior to that, he worked at Pfizer, joining in 1997, and rising to SVP and treasurer of Pfizer Inc., a position he held since 2001. In addition to that, Mr. Passov has also worked with Intel and Sun Microsystems.

Kristen C. Peck, EVP and Group President

Kristen Peck is EVP and Group President at Zoetis. Prior to this role, she served as EVP, Worldwide business development and Innovation at Pfizer Inc and also as a member of Pfizer's Executive Leadership Team. In the past she has worked at BCG, The Prudential Reality Group, The O'Connor Group and J.P.Morgan.

Clinton A. Lewis Jr., EVP and President of US operations

Clint Lewis is EVP and President of US operations at Zoetis. Prior to Zoetis, he served as President of US Operations for Pfizer's animal health business beginning in 2007 and has 24 years of experience in different roles at Pfizer. In 2011, he was elected chairman of the AHI for the 2011-12 term.

Alejandro Bernal, EVP and Area President of EUAFME

Alejandro Bernal has been Zoetis' EVP and area president of Europe, Africa & Middle East Region since October 2012 and led that region within Pfizer's animal health business beginning in 2010. Prior to that, he worked with Pfizer Animal Health for 12 years where he became a member of Animal Health Leadership Team in 2007 and also the Area President for Canada and Latin America region. In the past, Mr. Bernal has also worked at Aurora Dairy Corporation. In 2011, He was elected Chairman of IFAH Europe for a two-year term.

Joyce J. Lee, EVP and Area President of CLAR

Joyce Lee is Zoetis' EVP and Area President of the CLAR region. She became the Area President for that region as part of Pfizer Animal Health in 2010.She has 10 years of experience at Pfizer and has also served as VP, Global Poultry at Pfizer Animal Health.

Stefan Weiskopf, EVP and Area President of Asia Pacific region

Stefan Weiskopf was appointed EVP and Area President of the Asia Pacific region at Zoetis in October 2012. Prior to that, he served as Area President of the Asia Pacific region in the Pfizer Animal Health organization since 2007 and had overseen company's operation in Germany, Austria and Switzerland in the past. He has worked with Pfizer Animal Health since 1986 and used to practice veterinary medicine before entering the pharmaceutical industry.

Catherine A. Knupp, EVP and President of R&D

Cathy Knupp is EVP and President of R&D at Zoetis. She served as Vice President, Veterinary Medicine Research and Development at Pfizer Animal Health since 2005. Prior to Pfizer Animal Health, she worked in Pfizer Michigan laboratories leading pharmacokinetics, dynamics, and metabolism. She also chaired the Midwest Exploratory Development Management Team in Pfizer Global R&D. Previously, she worked at Bristol-Myers Squibb.

Financial Outlook

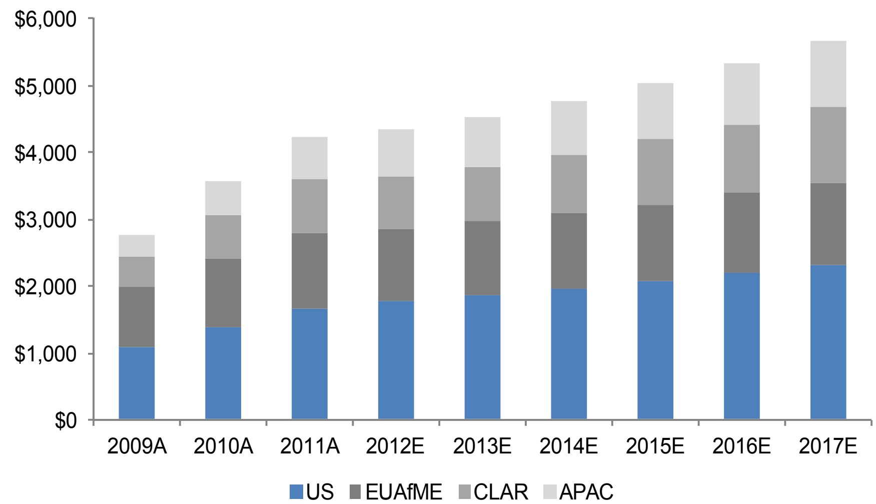
Top-line Growth Led by Emerging Markets

We see Zoetis' annual revenue growth in the 5%-6% range through 2017 driven improving US performance as well as ongoing solid emerging market growth in Latin America and increasingly Asia. In the near term, we are expecting slightly lower top-line growth in 2013 of roughly 4% as the company works through the residual impact of the drought in the US. The drought has resulted in higher feed prices and a smaller overall US cattle herd, which is Zoetis most important species in the US. While currently the company's smallest region, we see APAC as the highest growth geography for Zoetis, with CLAR not far behind, driven by healthy growth in Latin America.

Drought Impact

We will closely watch US results in 2013 for any lingering impact of reduced herd sizes from the major drought experienced by a broad portion of the US market in 2012. US growth decelerated over the course of 2012 from 12% in the first quarter to 8% and then 2% in the second and third quarters of 2012, respectively. That said, Pfizer reported 8% US growth for animal health in 4Q/12, and Pfizer's reported results track fairly closely to Zoetis historic numbers. We are assuming only 3% top-line growth for Zoetis' US business in 1H/13.

Figure 27: Revenue Projections
$ In millions



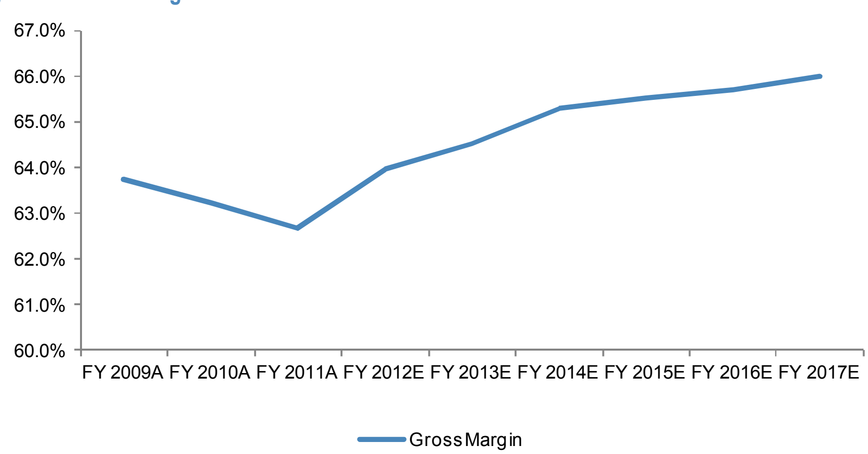
Source: J.P. Morgan estimates.

We Expect Modest Gross Margin Improvement over Time

We forecast gross margins of 64.5% for 2013, up slightly from 2012 levels. Thereafter, we see ran average of 40 basis points of GM expansion per year through 2017 with GMs ultimately reaching 66%, or 300 basis points of improvement relative to estimated 2012 levels.

Zoetis has a very fragmented manufacturing network consisting of roughly 30 Zoetis sites as well as a number of arrangements with Pfizer as well as contract manufacturers that account for a majority of the company's sales. While Zoetis believes this diversified manufacturing network best serves its current needs, we would not be surprised to see consolidation of portions of this infrastructure over time and gross margin expansion beyond what we have modeled for the company.

Figure 28: Gross Margin

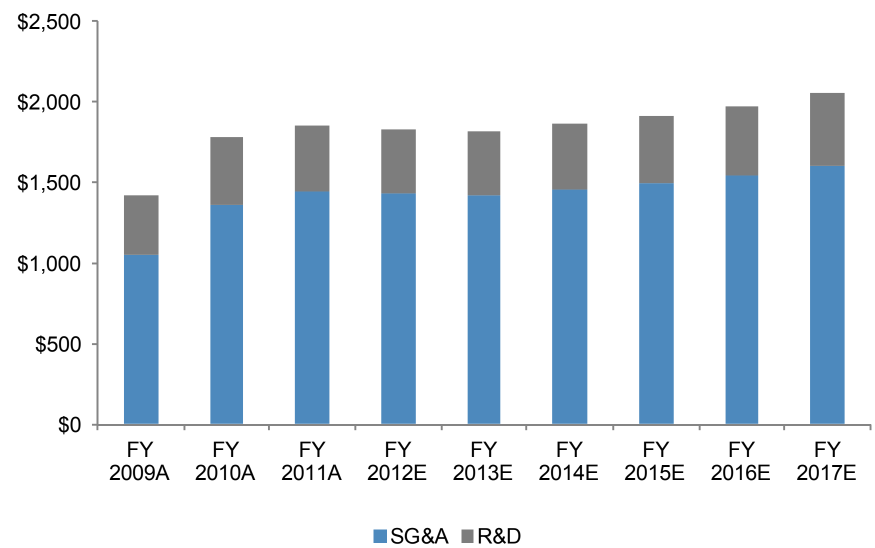


Source: J.P. Morgan estimates.

Forecasting Only Modest Operating Expense Growth

Wee see roughly 2-3% growth for Zoetis' operating expenses through 2017. Zoetis has invested in building out its global sales infrastructure and has a direct selling presence in 70 countries and along these lines we see a limited need for significant step-ups in SG&A spend going forward. In addition, with an R&D budget of $400 million largely focused on line extension and lifecycle management, we also do not foresee the need for a significant step-up in R&D spend. In our view, the animal health model is inherently scalable as additional product sales into existing accounts and modest price increase should allow for top-line growth above that of expense growth.

Figure 29: SG&A and R&D projections
$ In millions

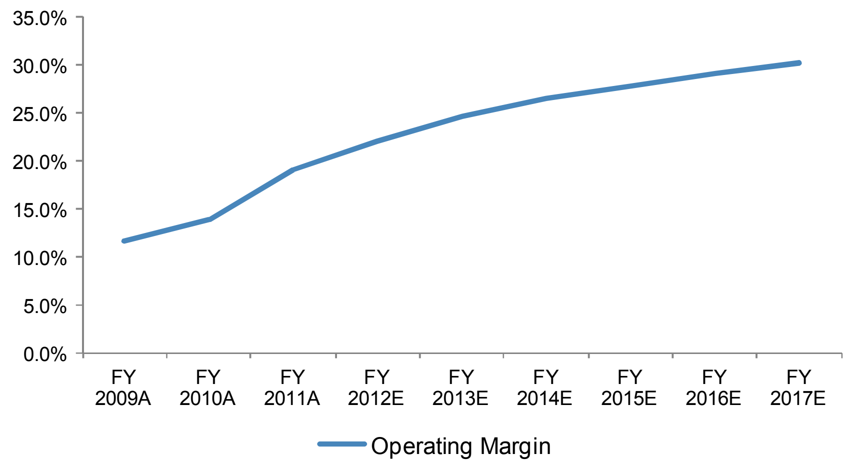


Source: J.P. Morgan estimates.

Operating Margin Expansion Driven By SG&A Leverage

With mid-single digit top-line growth, modest improvement in gross margins, and operating expenses, particularly SG&A growth in the low single digits, we forecast healthy operating margin expansion for Zoetis through 2017. We model operating margins expanding from 24.7% in 2013 to 30.2% by 2017, or roughly 550 basis points of improvement.

Figure 30: Operating Margin



Source: J.P. Morgan estimates.

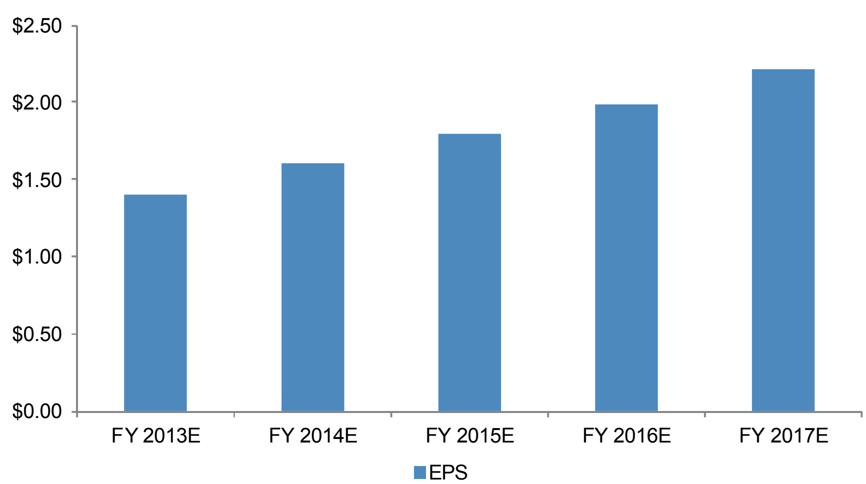
Forecasting Flat Tax Rate; Improvement Would Be Upside

We forecast a flat 29% tax rate for Zoetis going forward. This is below the pro-forma mid-30%s tax rate the company reported as part of Pfizer. We believe with some straightforward tax planning Zoetis will be able to drop its tax rate down to the 29% range. Longer-term, we would not be surprised to see a further opportunity to bring down the company's tax rate when we look across the rest of our global pharma companies which have tax rates in the low/mid-20%s depending on the company’s capital deployment priorities.

EPS: 12% CAGR Through 2017

Putting all of these forecasts together, we forecast a 12% EPS CAGR from 2013-2017.

Figure 31: EPS projections
$

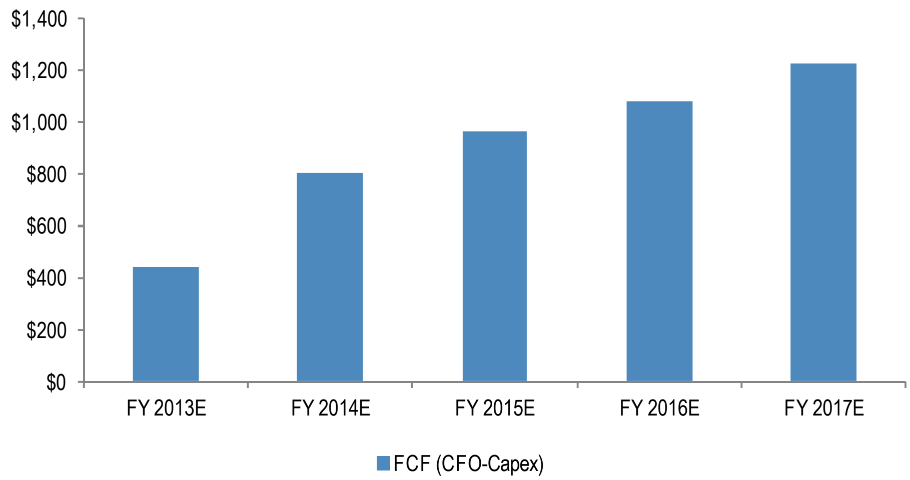


Source: J.P. Morgan estimates.

We See Zoetis in a Net Cash Position by 2017

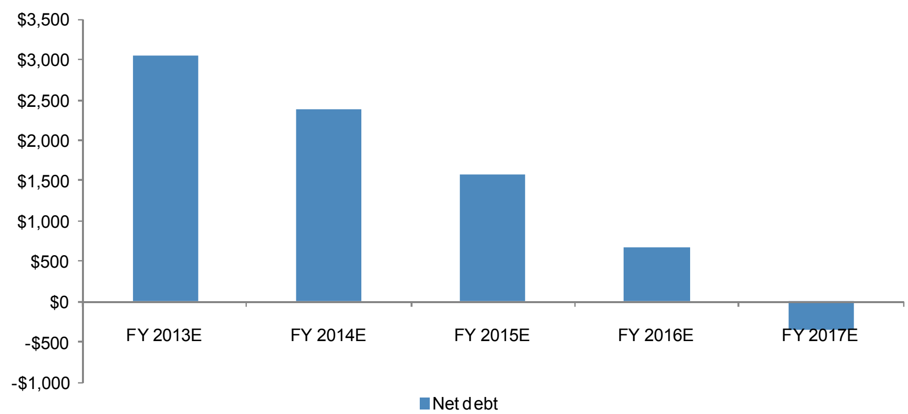
Despite a modest current cash balance and not-insignificant debt ($3.65 billion), we see solid cash flow growth for the company over the next several years. We would note that we see 2013 and 2014 cash flow as somewhat depressed by one-time cash expenses as part of separating from Pfizer. We currently model these after-tax cash outlays (not part of the non-GAAP P&L) at $175 million in 2013 and $100 million in 2014, but expect these to substantially fall away in 2015 and beyond.

Figure 32: FCF Projections
$ millions



Source: J.P. Morgan estimates.

Figure 33: Net Debt
$ In millions



Source: J.P. Morgan estimates.

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Figure 34: Zoetis P&L

$ in millions

millions USD Fiscal year ends December 31	FY 2009A	FY 2010A	FY 2011A	FY 2012E	Mar 2013 1QE	Jun 2013 2QE	Sep 2013 3QE	Dec 2013 4QE	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E
Income Statement													
Revenue													
Total Revenue	2,760	3,582	4,233	4,334.5	1,077.4	1,124.0	1,075.8	1,233.9	4,511.1	4,750.1	5,023.6	5,326.7	5,668.2
Cost of Revenue	1,001	1,318	1,581	1,562.4	387.9	404.6	371.1	438.0	1,601.7	1,648.3	1,733.1	1,827.1	1,927.2
Gross Profit	1,759.0	2,264.0	2,652.0	2,772.1	689.5	719.4	704.6	795.9	2,909.4	3,101.8	3,290.4	3,499.7	3,741.0
Operating Expenses													
SG&A	1,057	1,365	1,447	1,428.9	331	351	328	407	1,417.3	1,456.3	1,496.3	1,541.2	1,602.9
R&D	365	411	407	401.3	95	93	91	117	396.3	406.3	416.4	428.9	446.1
Amortization of intangible assets	16	17	20	14.5	4	4	4	4	14.0	14.0	14.0	14.0	14.0
Other expenses	(1)	(25)	(28)	(28.0)	(8)	(8)	(8)	(8)	(32.0)	(35.0)	(35.0)	(35.0)	(35.0)
Total Operating Expenses	1,437.0	1,768.0	1,846.0	1,816.8	421.4	439.3	415.1	519.9	1,795.7	1,841.5	1,891.7	1,949.1	2,027.9
Income (Loss) from Operations	322.0	496.0	806.0	955.3	268	280	290	276	1,113.8	1,260.3	1,398.7	1,550.5	1,713.1
Other (Income)/Expense	-	-	-	-					-	-	-	-	-
Interest Income					(1)	(1)	(1)	(1)	(3)	(6)	(9)	(11)	(14)
Interest Expense	26.0	37.0	36.0	30.0	29	29	29	29	117	117	109	102	84
Total Interest and Other (Income)	26.0	37.0	36.0	30.0	28	28	28	28	120	111	100	90	70
Income (Loss) Before Income Taxes	296.0	459.0	770.0	925.3	240	252	261	248	994.0	1,149.7	1,299.0	1,460.1	1,642.8
Taxes	108	183	264	314.6	70	73	76	72	288	333	377	423	476
non-controlling interest	(1)	1	3	-	-	-	-	-	-	-	-	-	-
Net Income	189	275	503	610.7	170	179	185	176	705.7	816.3	922.3	1,036.7	1,166.4
Adjusted EPS (diluted)					$ 0.34	$ 0.35	$ 0.37	$ 0.35	$ 1.40	$ 1.60	$ 1.79	$ 1.99	$ 2.22
Share Count (diluted)					505	505	505	505	505	510	515	520	526

Margins	FY 2009A	FY 2010A	FY 2011A	FY 2012E	Mar 2013 1QE	Jun 2013 2QE	Sep 2013 3QE	Dec 2013 4QE	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E
Gross margin	**63.7%**	**63.2%**	**62.7%**	**64.0%**	**64.0%**	**64.0%**	**65.5%**	**64.5%**	**64.5%**	**65.3%**	**65.5%**	**65.7%**	**66.0%**
SG&A	38.3%	38.1%	34.2%	33.0%	30.7%	31.2%	30.5%	33.0%	31.4%	30.7%	29.8%	28.9%	28.3%
R&D	13.2%	11.5%	9.6%	9.3%	8.8%	8.3%	8.5%	9.5%	8.8%	8.6%	8.3%	8.1%	7.9%
Operating margin	**11.7%**	**13.8%**	**19.0%**	**22.0%**	**24.9%**	**24.9%**	**26.9%**	**22.4%**	**24.7%**	**26.5%**	**27.8%**	**29.1%**	**30.2%**
Pretax margin	**10.7%**	**12.8%**	**18.2%**	**21.3%**	**22.3%**	**22.4%**	**24.3%**	**20.1%**	**22.0%**	**24.2%**	**25.9%**	**27.4%**	**29.0%**
Tax rate	36.5%	39.9%	34.3%	34.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%
Net margin	**6.8%**	**7.7%**	**11.9%**	**14.1%**					**15.6%**	**17.2%**	**18.4%**	**19.5%**	**20.6%**

Growth Rates	FY 2009A	FY 2010A	FY 2011A	FY 2012E	Mar 2013 1QE	Jun 2013 2QE	Sep 2013 3QE	Dec 2013 4QE	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E
Revenue		29.8%	18.2%	2.4%	2.9%	2.7%	5.6%	5.1%	4.1%	5.3%	5.8%	6.0%	6.4%
Gross profit		28.7%	17.1%	4.5%	4.6%	1.0%	5.6%	8.4%	5.0%	6.6%	6.1%	6.4%	6.9%
SG&A		29.1%	6.0%	-2.5%	0.0%	0.0%	-0.6%	-2.3%	-0.8%	2.8%	2.8%	3.0%	4.0%
R&D		12.6%	-1.0%	-2.5%	2.0%	2.0%	-2.7%	-4.9%	-1.2%	2.5%	2.5%	3.0%	4.0%
Operating income		54.0%	62.5%	18.5%	13.2%	2.2%	16.3%	41.3%	16.6%	13.2%	11.0%	10.9%	10.5%
Pretax income		55.1%	67.8%	20.2%	4.7%	-5.4%	7.9%	31.5%	7.4%	15.7%	13.0%	12.4%	12.5%
Net income		45.5%	82.9%	21.4%	12.0%	1.5%	20.4%	43.6%	15.6%	15.7%	13.0%	12.4%	12.5%
EPS													

Source: Company reports and J.P. Morgan estimates.

Figure 35: Zoetis Balance Sheet

$ in millions

	2013E	2014E	2015E	2016E	2017E
Assets					
Cash & cash equivalents	602	1,261	1,821	2,225	2,750
Accounts receivable	940	950	977	1036	1102
Inventories	1001	916	842	761	669
Current deferred tax assets	96	96	96	96	96
Other current assets	202	202	202	202	202
Total current assets	2,841	3,425	3,938	4,320	4,819
PP&E	1,318	1,333	1,333	1,333	1,333
Intangible assets	928	928	928	928	928
Goodwill	989	989	989	989	989
Noncurrent deferred tax assets	143	143	143	143	143
Other noncurrent assets	97	97	97	97	97
Total assets	6,316	6,915	7,428	7,810	8,309
Liabilities and Equity					
Current portion of allocated long-term debt	-	-	-	-	-
Accounts payable	222	229	241	254	268
Income taxes payable	18	18	18	18	18
Accrued compensation and related items	150	150	150	150	150
Other current liabilities	461	461	461	461	461
Total current liabilities	851	858	870	883	897
Allocated long-term debt	3,650	3,650	3,400	2,900	2,400
Noncurrent deferred tax liabilities	311	311	311	311	311
Other taxes payable	122	122	122	122	122
Other noncurrent liabilities	124	124	124	124	124
Total liabilities	5,058	5,065	4,827	4,340	3,854
Commitments and Contigencies					
Business unit equity	1,306	1,899	2,650	3,519	4,505
Accumulated other comprehensive loss	(65)	(65)	(65)	(65)	(65)
Total Zoetis equity	1,241	1,834	2,585	3,454	4,440
Equity attributable to noncontrolling interests	16	16	16	16	16
Total Equity	1,257	1,850	2,601	3,470	4,456
Total liability and Equity	6,316	6,915	7,428	7,810	8,309

Source: Company reports and J.P. Morgan estimates.

Figure 36: Zoetis Cash Flow

$ in millions

	2013E	2014E	2015E	2016E	2017E
Assets					
Cash & cash equivalents	602	1,261	1,821	2,225	2,750
Accounts receivable	940	950	977	1036	1102
Inventories	1001	916	842	761	669
Current deferred tax assets	96	96	96	96	96
Other current assets	202	202	202	202	202
Total current assets	2,841	3,425	3,938	4,320	4,819
PP&E	1,318	1,333	1,333	1,333	1,333
Intangible assets	928	928	928	928	928
Goodwill	989	989	989	989	989
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Total Equity	1,257	1,850	2,601	3,470	4,456
Total liability and Equity	6,316	6,915	7,428	7,810	8,309

Source: Company reports and J.P. Morgan estimates.

Zoetis: Summary of Financials

Income Statement - Annual	FY11A	FY12E	FY13E	FY14E	Income Statement - Quarterly	1Q12A	2Q12A	3Q12A	4Q12E
Revenues	4,233	4,334	4,511	4,750	Revenues	-	-	-	-
Cost of products sold	1,581	1,562	1,602	1,648	Cost of products sold	-	-	-	-
Gross profit	2,652	2,772	2,909	3,102	Gross profit	-	-	-	-
SG&A	1,447	1,429	1,417	1,456	SG&A	-	-	-	-
R&D	407	401	396	406	R&D	-	-	-	-
Operating Income	806	955	1,114	1,260	Operating income	-	-	-	-
Note: EBITDA	-	-	-	-	Note: EBITDA	-	-	-	-
Net interest income / (expense)	36	30	120	111	Net interest income / (expense)	-	-	-	-
Other income / (expense)	0	0	0	0	Other income / (expense)	-	-	-	-
Pretax income	770	925	994	1,150	Pretax income	-	-	-	-
Income taxes	264	315	288	333	Income taxes	-	-	-	-
Net income - GAAP	503	611	706	816	Net income - GAAP	-	-	-	-
Net income - recurring	-	-	-	-	Net income - recurring	-	-	-	-
Diluted shares outstanding	-	-	505	510	Diluted shares outstanding	-	-	-	-
EPS - excluding non-recurring	-	-	1.40	1.60	EPS - excluding non-recurring	-	-	-	-
EPS - recurring	-	-	-	-	EPS - recurring	-	-	-	-

Balance Sheet and Cash Flow Data	FY11A	FY12E	FY13E	FY14E	Ratio Analysis	FY11A	FY12E	FY13E	FY14E
Cash and cash equivalents	79	289	602	1,261	Sales growth	18.2%	2.4%	4.1%	5.3%
Accounts receivable	871	903	940	950	EBIT growth	62.5%	18.5%	16.6%	13.2%
Inventories	1,063	977	1,001	916	EPS growth	-	-	-	-
Other current assets	298	298	298	298					
Current assets	2,311	2,467	2,841	3,425	Gross margin	62.7%	64.0%	64.5%	65.3%
PP&E	1,243	1,268	1,318	1,333	EBIT margin	19.0%	22.0%	24.7%	26.5%
Total assets	5,711	5,892	6,316	6,915	EBITDA margin	-	-	-	-
					Tax rate	34.3%	34.0%	29.0%	29.0%
Total debt	575	3,650	3,650	3,650	Net margin	11.9%	14.1%	15.6%	17.2%
Total liabilities	1,975	5,053	5,058	5,065					
Shareholders' equity	3,736	839	1,257	1,850	Debt / EBITDA	-	-	-	-
					Debt / Capital (book)	10.0%	62.0%	58.0%	53.0%
Net income (including charges)	248	611	706	816	Return on assets (ROA)	0.0%	0.0%	0.0%	0.0%
D&A	205	145	120	120	Return on equity (ROE)	0.0%	0.0%	0.0%	0.0%
Change in working capital	(117)	57	(56)	82	Return on invested capital (ROIC)	-	-	-	-
Other									
Cash flow from operations	497	832	614	937	Enterprise value / sales	-	-	-	-
					Enterprise value / EBITDA	-	-	-	-
Capex	(135)	(170)	(170)	(135)	Free cash flow yield	-	-	2.6%	4.6%
Free cash flow	362	662	444	802					
Cash flow from investing activities	(449)	(170)	(170)	(135)					
Cash flow from financing activities	(30)	(452)	(131)	(143)					
Dividends	-	-	-	-					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Dec

Other Companies Recommended in This Report (all prices in this report as of market close on 12 March 2013)
Pfizer Inc. (PFE/$27.94/Overweight)

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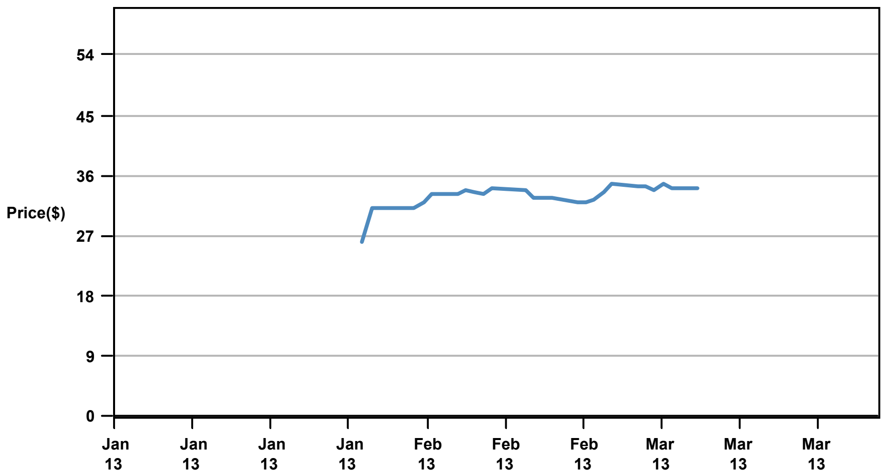
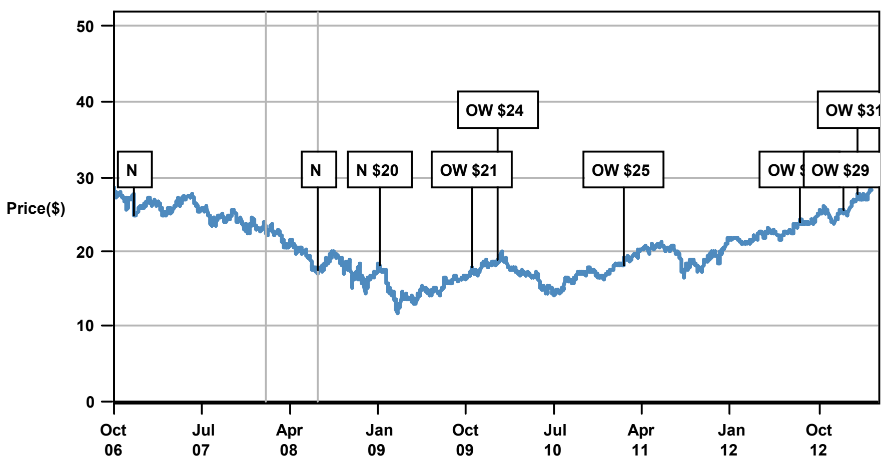
Zoetis (ZTS, ZTS US) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.

Pfizer Inc. (PFE, PFE US) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
04-Dec-06	N	24.90	--
24-Jun-08	N	17.69	--
06-Jan-09	N	18.16	20.00
16-Oct-09	OW	17.77	21.00
05-Jan-10	OW	18.93	24.00
01-Feb-11	OW	18.22	25.00
31-Jul-12	OW	23.94	28.00
13-Dec-12	OW	25.51	29.00
30-Jan-13	OW	27.70	31.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Dec 04, 2006 - Jun 24, 2008.

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