

Zoetis

Updating Model Following 10-K, Next Up: 2013 Guidance

We are updating our model following Zoetis' 10-K released Thursday night. While Pfizer's results provided some insight into sales in the quarter, ZTS's formal full year results confirmed solid 4Q/12 sales results (+4% reported, estimated +7% cc) as well as regional sales that were roughly in-line with our forecasts. Looking down the P&L in the quarter, 4Q/12 results provide limited insight into ZTS's margins going forward, in our view, and we see the next key update as the company's 1Q/13 results and initial 2013 guidance (April 30).

We continue to see Zoetis as a 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. As the clear leader in its industry, we see ZTS capable of generating sustainable mid-single digit top-line growth and low to mid-teens EPS growth.

- **Solid 4Q sales show substantial acceleration from 3Q results.** Sales in the fourth quarter were in line with our forecast at \$1,176mm (+4% YOY, +\$2mm vs. JPMe) with each of the company's four regions also more or less in line (US: \$482mm, -\$3mm vs. JPME, EuAfME: \$297mm, +\$10mm vs. JPMe, CLAR: \$220mm, -\$7mm vs. JPMe, and APAC: \$177, +\$2mm vs. JPMe). We continue to believe our 1H/13 sales estimates (3% growth) for ZTS could be conservative based on these results.
- **Limited read-through from 4Q margins.** Adjusted operating margins fell to 15.5% in the fourth quarter after averaging 24% in the first nine months of the year, although we have a difficult time reading much into these results. That said, we remain comfortable with our expectation for 2013 operating margins of 24-25% and going forward expect 4Q will represent ZTS's lowest operating margins of its fiscal year.
- **Next update: 1Q results and 2013 guidance.** We expect the next update for Zoetis to be first quarter results on April 30, the company's first quarter since the IPO. In addition, we expect the company to provide 2013 guidance when it reports 1Q, and expect guidance that brackets our 2013 forecast of \$1.40, in line with the Street.

Overweight

ZTS, ZTS US

Price: \$33.40

Price Target: \$39.00

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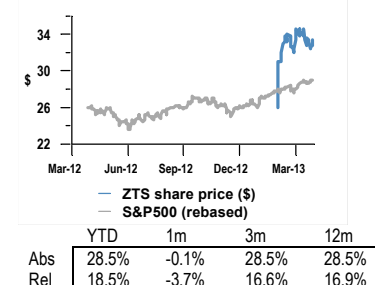
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Price Performance



Zoetis (ZTS;ZTS US)

| FYE Dec | 2012A | 2013E (Prev) | 2013E (Curr) | 2014E | 2015E |
|-----------------------|-------|-----------------|-----------------|-------|-------|
| EPS Adjusted (\$) | | | | | |
| Q1 (Mar) | - | 0.34 | 0.34 | - | - |
| Q2 (Jun) | - | 0.35 | 0.35 | - | - |
| Q3 (Sep) | - | 0.37 | 0.37 | - | - |
| Q4 (Dec) | - | 0.35 | 0.34 | - | - |
| FY | - | 1.40 | 1.40 | 1.60 | 1.79 |
| Bloomberg EPS FY (\$) | 1.23 | - | 1.38 | 1.61 | 1.78 |

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

Company Data

| | |
|-----------------------|---------------|
| Price (\$) | 33.40 |
| Date Of Price | 28 Mar 13 |
| 52-week Range (\$) | 35.42 - 26.00 |
| Mkt Cap (\$ mn) | 16,867.00 |
| Fiscal Year End | Dec |
| Shares O/S (mn) | 505 |
| Price Target (\$) | 39.00 |
| Price Target End Date | 31 Dec 13 |

See page 6 for analyst certification and important disclosures.

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Changes to Estimates

Table 1: Changes to Estimates

\$ in millions

| ZTS | | | | Sales | | | |
|-------|---------|----------|------------|-------|---------|----------|------------|
| Year | Revised | Previous | Difference | Year | Revised | Previous | Difference |
| 2013E | \$1.40 | \$1.40 | \$0.00 | 2013E | \$4,512 | \$4,511 | \$1 |
| 2014E | \$1.60 | \$1.60 | \$0.00 | 2014E | \$4,751 | \$4,750 | \$0 |
| 2015E | \$1.79 | \$1.79 | \$0.00 | 2015E | \$5,023 | \$5,024 | (\$0) |
| 2016E | \$2.00 | \$1.99 | \$0.01 | 2016E | \$5,326 | \$5,327 | (\$1) |
| 2017E | \$2.23 | \$2.22 | \$0.01 | 2017E | \$5,667 | \$5,668 | (\$1) |
| 2018E | \$2.48 | \$2.48 | \$0.00 | 2018E | \$6,010 | \$6,011 | (\$1) |
| 2019E | \$2.76 | \$2.75 | \$0.01 | 2019E | \$6,342 | \$6,344 | (\$2) |
| 2020E | \$3.08 | \$3.08 | \$0.00 | 2020E | \$6,695 | \$6,697 | (\$2) |

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

Investment Thesis

Maintain Overweight rating. 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.

Valuation

Zoetis trades at 23.9x our 2013 EPS estimate of \$1.40. This represents a 6% premium to its healthy-growth comps (AGN, PRGO, MJN, MON). Recall that these names trade at a substantial 55-60% premium to the S&P 500 on 2013E P/E.

Maintain Dec-13 price target of \$39. 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 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).

Risks to Rating and Price Target

Risks to our Overweight rating on Zoetis include increasing regulation on the use of antibiotics in healthy farm animals, greater-than-expected impact from the US drought, and broader economic volatility, which would impact demand for Zoetis' products.

Figure 1: Zoetis P&L

\$ in millions

| millions USD Fiscal year ends December 31 | FY 2009A | FY 2010A | FY 2011A | Mar 2012 1QA | Jun 2012 2QA | Sep 2012 3QA | Dec 2012 4QA | FY 2012A | Mar 2013 1QE | Jun 2013 2QE | Sep 2013 3QE | Dec 2013 4QE | FY 2013E | FY 2014E | FY 2015E | FY 2016E | FY 2017E | FY 2018E | FY 2019E | FY 2020E |
|----------------------------------------------|----------|----------|----------|-----------------|-----------------|-----------------|-----------------|----------|-----------------|-----------------|-----------------|-----------------|----------|----------|----------|----------|----------|----------|----------|----------|
| Income Statement | | | | | | | | | | | | | | | | | | | | |
| Revenue | | | | | | | | | | | | | | | | | | | | |
| Total Revenue | 2,760 | 3,582 | 4,233 | 1,047 | 1,094 | 1,019.0 | 1,176.0 | 4,336.0 | 1,077.4 | 1,124.0 | 1,075.8 | 1,234.8 | 4,512.0 | 4,750.5 | 5,023.5 | 5,326.2 | 5,667.2 | 6,009.8 | 6,342.3 | 6,695.0 |
| Cost of Revenue | 1,001 | 1,318 | 1,581 | 388 | 382 | 352 | 427 | 1,549.0 | 387.9 | 404.6 | 371.1 | 438.3 | 1,602.0 | 1,648.4 | 1,733.1 | 1,826.9 | 1,926.9 | 2,013.3 | 2,093.0 | 2,175.9 |
| Gross Profit | 1,759.0 | 2,264.0 | 2,652.0 | 659 | 712 | 667.0 | 749.0 | 2,787.0 | 689.5 | 719.4 | 704.6 | 796.4 | 2,910.0 | 3,102.1 | 3,290.4 | 3,499.3 | 3,740.4 | 3,996.5 | 4,249.4 | 4,519.2 |
| Operating Expenses | | | | | | | | | | | | | | | | | | | | |
| SG&A | 1,057 | 1,365 | 1,447 | 331 | 351 | 330 | 440 | 1,452.0 | 331 | 351 | 328 | 411 | 1,420.7 | 1,456.2 | 1,496.2 | 1,541.1 | 1,602.8 | 1,658.9 | 1,708.6 | 1,755.6 |
| R&D | 365 | 411 | 407 | 93 | 91 | 94 | 121 | 399.0 | 95 | 93 | 91 | 117 | 396.4 | 406.3 | 416.5 | 429.0 | 446.1 | 459.5 | 473.3 | 485.2 |
| Amortization of intangible assets | 16 | 17 | 20 | 4 | 3 | 4 | 4 | 15.0 | 4 | 4 | 4 | 4 | 14.0 | 14.0 | 14.0 | 14.0 | 14.0 | 14.0 | 14.0 | 14.0 |
| Other expenses | (1) | (25) | (28) | (6) | (7) | (10) | 2 | (21.0) | (8) | (8) | (8) | (8) | (32.0) | (35.0) | (35.0) | (35.0) | (35.0) | (35.0) | (35.0) | (35.0) |
| Total Operating Expenses | 1,437.0 | 1,768.0 | 1,846.0 | 422 | 438 | 418.0 | 567.0 | 1,845.0 | 421.4 | 439.3 | 415.1 | 523.4 | 1,799.1 | 1,841.5 | 1,891.7 | 1,949.1 | 2,027.9 | 2,097.4 | 2,161.0 | 2,219.8 |
| Income (Loss) from Operations | 322.0 | 496.0 | 806.0 | 237 | 274 | 249.0 | 182.0 | 942.0 | 268 | 280 | 290 | 273 | 1,110.9 | 1,260.6 | 1,398.6 | 1,550.2 | 1,712.5 | 1,899.1 | 2,088.4 | 2,299.4 |
| Other (Income)/Expense | - | - | - | - | - | - | - | - | (1) | (1) | (1) | (1) | (3) | (6) | (9) | (11) | (14) | (16) | (19) | (21) |
| Interest Income | 26.0 | 37.0 | 36.0 | 8 | 8 | 7 | 8 | 31.0 | 26 | 30 | 30 | 30 | 116 | 120 | 112 | 95 | 78 | 70 | 61 | 53 |
| Interest Expense | 26.0 | 37.0 | 36.0 | 8 | 8 | 7 | 8 | 31.0 | 25 | 29 | 29 | 29 | 113 | 114 | 103 | 84 | 65 | 54 | 43 | 32 |
| Total Interest and Other (Income) | 26.0 | 37.0 | 36.0 | 8 | 8 | 7 | 8 | 31.0 | 25 | 29 | 29 | 29 | 113 | 114 | 103 | 84 | 65 | 54 | 43 | 32 |
| Income (Loss) Before Income Taxes | 296.0 | 459.0 | 770.0 | 229 | 266 | 242 | 174 | 911.0 | 243 | 251 | 260 | 244 | 997.9 | 1,146.8 | 1,296.0 | 1,466.3 | 1,648.0 | 1,845.5 | 2,045.7 | 2,267.4 |
| Taxes | 108 | 183 | 264 | 76 | 90 | 89 | 117 | 372.0 | 70 | 73 | 75 | 71 | 289.4 | 333 | 376 | 425 | 478 | 535 | 593 | 658 |
| non-controlling interest | (1) | 1 | 3 | 1 | - | (1) | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Net Income | 189 | 275 | 503 | 152 | 176 | 154 | 57 | 539.0 | 172 | 178 | 185 | 173 | 708.5 | 814.2 | 920.2 | 1,041.1 | 1,170.0 | 1,310.3 | 1,452.5 | 1,609.9 |
| Adjusted EPS (diluted) | | | | | | | | | \$ 0.34 | \$ 0.35 | \$ 0.37 | \$ 0.34 | \$1.40 | \$1.60 | \$1.79 | \$2.00 | \$2.23 | \$2.48 | \$2.76 | \$3.08 |
| Share Count (diluted) | | | | | | | | | 505 | 505 | 505 | 505 | 505 | 510 | 515 | 520 | 526 | 528 | 526 | 523 |
| Margins | | | | | | | | | | | | | | | | | | | | |
| Gross margin | 63.7% | 63.2% | 62.7% | 62.9% | 65.1% | 65.5% | 63.7% | 64.3% | 64.0% | 64.0% | 65.5% | 64.5% | 64.5% | 65.3% | 65.5% | 65.7% | 66.0% | 66.5% | 67.0% | 67.5% |
| SG&A | 38.3% | 38.1% | 34.2% | 31.6% | 32.1% | 32.4% | 37.4% | 33.5% | 30.7% | 31.2% | 30.5% | 33.3% | 31.5% | 30.7% | 29.8% | 28.9% | 28.3% | 27.6% | 26.9% | 26.2% |
| R&D | 13.2% | 11.5% | 9.6% | 8.9% | 8.3% | 9.2% | 10.3% | 9.2% | 8.8% | 8.3% | 8.5% | 9.5% | 8.8% | 8.6% | 8.3% | 8.1% | 7.9% | 7.6% | 7.5% | 7.2% |
| Operating margin | 11.7% | 13.8% | 19.0% | 22.6% | 25.0% | 24.4% | 15.5% | 21.7% | 24.9% | 24.9% | 26.9% | 22.1% | 24.6% | 26.5% | 27.8% | 29.1% | 30.2% | 31.6% | 32.9% | 34.3% |
| Pretax margin | 10.7% | 12.8% | 18.2% | 21.9% | 24.3% | 23.7% | 14.8% | 21.0% | 22.5% | 22.3% | 24.2% | 19.7% | 22.1% | 24.1% | 25.8% | 27.5% | 29.1% | 30.7% | 32.3% | 33.9% |
| Tax rate | 36.5% | 39.9% | 34.3% | 33.2% | 33.8% | 36.8% | 67.2% | 40.8% | 29.0% | 29.0% | 29.0% | 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% | 14.5% | 16.1% | 15.1% | 4.8% | 12.4% | 29.0% | 29.0% | 29.0% | 29.0% | 15.7% | 17.1% | 18.3% | 19.5% | 20.6% | 21.8% | 22.9% | 24.0% |
| Growth Rates | | | | | | | | | | | | | | | | | | | | |
| Revenue | | 29.8% | 18.2% | | | | | 2.4% | 2.9% | 2.7% | 5.6% | 5.0% | 4.1% | 5.3% | 5.7% | 6.0% | 6.4% | 6.0% | 5.5% | 5.6% |
| Gross profit | | 28.7% | 17.1% | | | | | 5.1% | 4.6% | 1.0% | 5.6% | 6.3% | 4.4% | 6.6% | 6.1% | 6.3% | 6.9% | 6.8% | 6.3% | 6.3% |
| SG&A | | 29.1% | 6.0% | | | | | 0.3% | 0.0% | 0.0% | -0.6% | -6.7% | -2.2% | 2.5% | 2.8% | 3.0% | 4.0% | 3.5% | 3.0% | 2.8% |
| R&D | | 12.6% | -1.0% | | | | | -2.0% | 2.0% | 2.0% | -2.7% | -3.1% | -0.6% | 2.5% | 2.5% | 3.0% | 4.0% | 3.0% | 3.0% | 2.5% |
| Operating income | | 54.0% | 62.5% | | | | | 16.9% | 13.2% | 2.2% | 16.3% | 50.0% | 17.9% | 13.5% | 11.0% | 10.8% | 10.5% | 10.9% | 10.0% | 10.1% |
| Pretax income | | 55.1% | 67.8% | | | | | 18.3% | 6.1% | -5.7% | 7.6% | 40.1% | 9.5% | 14.9% | 13.0% | 13.1% | 12.4% | 12.0% | 10.9% | 10.8% |
| Net income | | 45.5% | 82.9% | | | | | 7.2% | 13.5% | 1.2% | 20.0% | 203.7% | 31.4% | 14.9% | 13.0% | 13.1% | 12.4% | 12.0% | 10.9% | 10.8% |
| EPS | | | | | | | | | | | | | | | | | | | | |

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

Zoetis: Summary of Financials

| Income Statement - Annual | | | | | Income Statement - Quarterly | | | | |
|-------------------------------------|-------|-------|-------|-------|-----------------------------------|-------|-------|-------|-------|
| | FY12A | FY13E | FY14E | FY15E | | 1Q13E | 2Q13E | 3Q13E | 4Q13E |
| Revenues | 4,336 | 4,512 | 4,751 | 5,023 | Revenues | 1,077 | 1,124 | 1,076 | 1,235 |
| Cost of products sold | 1,549 | 1,602 | 1,648 | 1,733 | Cost of products sold | 388 | 405 | 371 | 438 |
| Gross profit | 2,787 | 2,910 | 3,102 | 3,290 | Gross profit | 690 | 719 | 705 | 796 |
| SG&A | 1,452 | 1,421 | 1,456 | 1,496 | SG&A | 331 | 351 | 328 | 411 |
| R&D | 399 | 396 | 406 | 416 | R&D | 95 | 93 | 91 | 117 |
| Operating Income | 942 | 1,111 | 1,261 | 1,399 | Operating income | 268 | 280 | 290 | 273 |
| Note: EBITDA | - | - | - | - | Note: EBITDA | - | - | - | - |
| Net interest income / (expense) | 31 | 113 | 114 | 103 | Net interest income / (expense) | 25 | 29 | 29 | 29 |
| Other income / (expense) | 0 | 0 | 0 | 0 | Other income / (expense) | - | - | - | - |
| Pretax income | 911 | 998 | 1,147 | 1,296 | Pretax income | 243 | 251 | 260 | 244 |
| Income taxes | 372 | 289 | 333 | 376 | Income taxes | 70 | 73 | 75 | 71 |
| Net income - GAAP | 539 | 708 | 814 | 920 | Net income - GAAP | 172 | 178 | 185 | 173 |
| Net income - recurring | - | - | - | - | Net income - recurring | - | - | - | - |
| Diluted shares outstanding | - | 505 | 510 | 515 | Diluted shares outstanding | 505 | 505 | 505 | 505 |
| EPS - excluding non-recurring | - | 1.40 | 1.60 | 1.79 | EPS - excluding non-recurring | 0.34 | 0.35 | 0.37 | 0.34 |
| EPS - recurring | - | - | - | - | EPS - recurring | - | - | - | - |
| Balance Sheet and Cash Flow Data | | | | | Ratio Analysis | | | | |
| | FY12A | FY13E | FY14E | FY15E | | FY12A | FY13E | FY14E | FY15E |
| Cash and cash equivalents | 317 | 371 | 1,149 | 1,716 | Sales growth | 2.4% | 4.1% | 5.3% | 5.7% |
| Accounts receivable | 900 | 940 | 950 | 977 | EBIT growth | 16.9% | 17.9% | 13.5% | 11.0% |
| Inventories | 1,345 | 1,113 | 916 | 842 | EPS growth | - | - | - | - |
| Other current assets | 302 | 302 | 302 | 302 | | | | | |
| Current assets | 2,864 | 2,726 | 3,317 | 3,837 | Gross margin | 64.3% | 64.5% | 65.3% | 65.5% |
| PP&E | 1,241 | 1,261 | 1,276 | 1,276 | EBIT margin | 21.7% | 24.6% | 26.5% | 27.8% |
| Total assets | 6,262 | 6,144 | 6,750 | 7,270 | EBITDA margin | - | - | - | - |
| | | | | | Tax rate | 40.8% | 29.0% | 29.0% | 29.0% |
| Total debt | 509 | 3,584 | 3,584 | 3,334 | Net margin | 12.4% | 15.7% | 17.1% | 18.3% |
| Total liabilities | 2,221 | 5,200 | 5,206 | 4,968 | | | | | |
| Shareholders' equity | 4,041 | 944 | 1,544 | 2,302 | Debt / EBITDA | - | - | - | - |
| | | | | | Debt / Capital (book) | 8.0% | 58.0% | 53.0% | 46.0% |
| Net income (including charges) | 436 | 708 | 814 | 920 | Return on assets (ROA) | 0.0% | 0.0% | 0.0% | 0.0% |
| D&A | 200 | 150 | 120 | 120 | Return on equity (ROE) | 0.0% | 0.0% | 0.0% | 0.0% |
| Change in working capital | (149) | 96 | 193 | 58 | Return on invested capital (ROIC) | - | - | - | - |
| Other | | | | | | | | | |
| Cash flow from operations | 454 | 807 | 1,055 | 1,092 | Enterprise value / sales | - | - | - | - |
| | | | | | Enterprise value / EBITDA | - | - | - | - |
| Capex | (126) | (170) | (135) | (120) | Free cash flow yield | - | 3.7% | 5.3% | 5.5% |
| Free cash flow | 328 | 637 | 920 | 972 | | | | | |
| Cash flow from investing activities | (135) | (170) | (135) | (120) | | | | | |
| Cash flow from financing activities | (78) | (583) | (143) | (405) | | | | | |
| Dividends | - | - | - | - | | | | | |
| Dividend yield | - | - | - | - | | | | | |

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

Note: \$ in millions (except per-share data). Fiscal year ends Dec

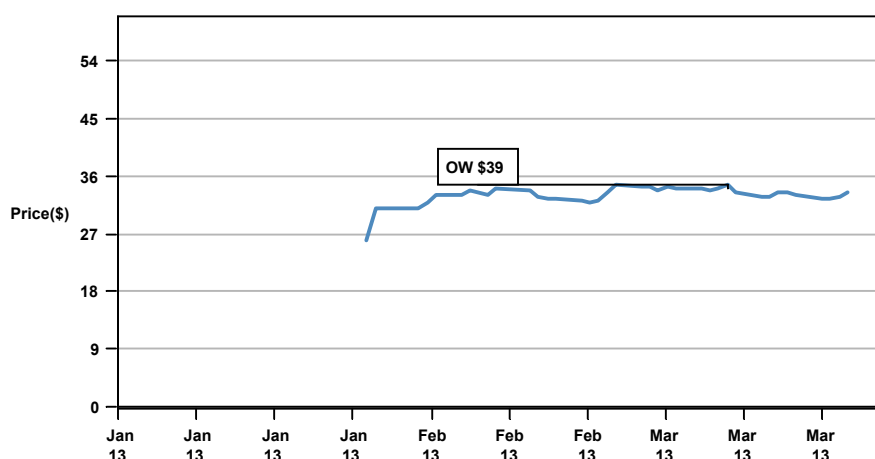
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Zoetis (ZTS, ZTS US) Price Chart



| Date | Rating | Share Price (\$) | Price Target (\$) |
|-----------|--------|------------------|-------------------|
| 13-Mar-13 | OW | 34.00 | 39.00 |

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 13, 2013.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

J.P. Morgan ratings or designations: OW = Overweight, N= Neutral, UW = Underweight, NR = Not Rated

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|---------------------------------------------|---------------------|-------------------|-----------------------|
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