

## Zoetis

### Well Positioned Post 2Q/13 Results, Reiterate OW

Despite significant levels of investor concern heading into earnings, Zoetis's 2Q results offered a combination of solid operational growth (+4%) as well as continued expense management, and we see ZTS as well positioned heading into the second half of the year. From here, we expect stronger operational growth for Zoetis as comparisons ease, and we believe our long-term margin expansion thesis for Zoetis is very much on track. Overall, 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. Reiterate Overweight.

- Top-line guidance maintained despite incremental FX headwinds.** While FX has moved incrementally against the company since 2013 guidance was issued, Zoetis maintained its 2013 top-line range, which we believe is in part due to better than expected underlying operational growth. Looking ahead in the year, we see improving operational growth in the third quarter (6%) as we annualize 2012 results that were impacted by the severe drought in the US last year.
- Another quarter of lower than expected opex; margin expansion story continues.** Zoetis reported lower than expected operating expenses for the second straight quarter, and we continue to have a high level of confidence in the potential for margin expansion in the company. In addition to its quarterly performance, manufacturing plans have already been put into place to offset 50% of the expected 2015 step-up in expenses on Pfizer manufactured products, and we anticipate additional manufacturing efficiencies from the organization over the next several years.

## Overweight

ZTS, ZTS US

Price: \$31.13

Price Target: \$39.00

### Pharmaceuticals — Major & Specialty

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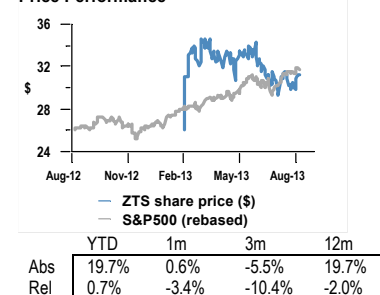
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### Price Performance



### Zoetis (ZTS;ZTS US)

FYE Dec	2013E (Prev)	2013E (Curr)	2014E	2015E (Prev)	2015E (Curr)
EPS Reported (\$)					
Q1 (Mar)	0.36A	0.36A	-	-	-
Q2 (Jun)	0.35A	0.36A	-	-	-
Q3 (Sep)	0.34	0.35	-	-	-
Q4 (Dec)	0.34	0.34	-	-	-
FY	1.39	1.40	1.59	1.81	1.82
CONSENSUS_EPS					
Bloomberg EPS FY (\$)	-	1.40	1.62	-	1.81

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

### Company Data

Price (\$)	31.13
Date Of Price	06 Aug 13
52-week Range (\$)	35.42-26.00
Market Cap (\$ mn)	15,596.13
Fiscal Year End	Dec
Shares O/S (mn)	501
Price Target (\$)	39.00
Price Target End Date	31-Dec-14

### See page 6 for analyst certification and important disclosures.

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## 2Q/13 Results

Table 1: 2Q/13 Results vs. Estimates

\$ in millions

Zoetis	JPM 2Q13E	Reported 2Q13A	Variance
<b>Total Revenue</b>	<b>\$1,107</b>	<b>\$1,114</b>	<b>\$7</b>
US	\$434	\$437	\$3
EuAfME	\$277	\$278	\$1
CLAR	\$213	\$213	\$0
APAC	\$183	\$186	\$3
<b>Cost of Revenues</b>	<b>\$398</b>	<b>\$400</b>	<b>\$2</b>
Gross Profit	\$708	\$714	\$6
Gross Margin	64.0%	64.1%	0.09%
SG&A	\$343	\$339	-\$4
R&D	\$94	\$91	-\$3
<b>Operating Income</b>	<b>\$268</b>	<b>\$281</b>	<b>\$13</b>
<b>Operating Margin</b>	<b>24.2%</b>	<b>25.2%</b>	<b>1.04%</b>
Other Income	-\$22	-\$29	-\$7
Tax Rate	29.5%	29.4%	-0.13%
Net Income	\$173	\$178	\$5
<b>EPS</b>	<b>\$0.35</b>	<b>\$0.36</b>	<b>\$0.01</b>
Shares	501	501	0.0

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

## Updates to Estimates

Table 2: Changes to EPS and Sales Forecasts

ZTS Year	EPS			Year	Sales		
	Revised	Previous	Difference		Revised	Previous	Difference
2013E	\$1.40	\$1.39	\$0.01	2013E	\$4,454	\$4,453	\$1
2014E	\$1.59	\$1.59	\$0.00	2014E	\$4,635	\$4,649	(\$14)
2015E	\$1.82	\$1.81	\$0.01	2015E	\$4,890	\$4,913	(\$24)
2016E	\$2.03	\$2.02	\$0.01	2016E	\$5,181	\$5,207	(\$26)
2017E	\$2.25	\$2.25	\$0.00	2017E	\$5,508	\$5,536	(\$28)
2018E	\$2.50	\$2.50	\$0.00	2018E	\$5,836	\$5,866	(\$31)
2019E	\$2.78	\$2.77	\$0.01	2019E	\$6,154	\$6,188	(\$33)
2020E	\$3.10	\$3.10	\$0.00	2020E	\$6,492	\$6,528	(\$36)

Source: J.P. Morgan estimates.

## Investment Thesis, Valuation and Risks

**Zoetis** (*Overweight; Price Target: \$39.00*)

### 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 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 22.2x our 2013 EPS estimate of \$1.40. This represents a 7% premium to its healthy-growth comps (AGN, PRGO, MJN, MON). Recall that these names trade at a substantial 35% premium to the S&P 500 on 2013E P/E.

**Establishing Dec 2014 price target of \$39.** Our prior Dec 2013 price target was \$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 five to seven 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% 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	Mar 2013 1QA	Jun 2013 2QA	Sep 2013 3QE	Dec 2013 4QE	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E	FY 2018E	FY 2019E	FY 2020E
<b>Income Statement</b>													
<b>Revenue</b>													
Total Revenue	2,760	1,090	1,114	1,062	1,188	4,454	4,635	4,890	5,181	5,508	5,836	6,154	6,492
Cost of Revenue	1,001	398	400	361	416	1,575	1,622	1,687	1,777	1,873	1,955	2,031	2,110
<b>Gross Profit</b>	1,759	692	714	701	772	2,879	3,013	3,203	3,404	3,635	3,881	4,123	4,382
<b>Operating Expenses</b>													
SG&A	1,057	322	339	329	398	1,388	1,388	1,416	1,458	1,517	1,570	1,617	1,657
R&D	365	90	91	96	107	383	391	401	413	427	440	453	465
Amortization of intangible assets	16	4	3	4	4	14	14	14	14	14	14	14	14
<b>Total Operating Expenses</b>	1,438	416	433	428	508	1,786	1,793	1,831	1,885	1,958	2,024	2,084	2,136
<b>Income (Loss) from Operations</b>	321	276	281	272	264	1,093	1,219	1,372	1,519	1,677	1,857	2,039	2,246
Other (Income)/Expense	(1)	2	(3)	(5)	(8)	(14)	(25)	(25)	(25)	(25)	(25)	(25)	(25)
Net Interest Expense	26.0	22	32	30	29	113	115	103	84	65	54	43	32
<b>Total Interest and Other (Income)</b>	25.0	24	29	25	21	99	90	78	59	40	29	18	7
<b>Income (Loss) Before Income Taxes</b>	296.0	252	252	247	243	994	1,130	1,294	1,459	1,637	1,828	2,021	2,240
Taxes	108	73	74	73	72	292	328	375	423	475	530	586	649
non-controlling interest	(1)	-	-	-	-	-	-	-	-	-	-	-	-
<b>Net Income</b>	189	179	178	174	171	703	802	919	1,036	1,163	1,298	1,435	1,590
<b>Adjusted EPS (diluted)</b>		\$ 0.36	\$ 0.36	\$ 0.35	\$ 0.34	\$1.40	\$1.59	\$1.82	\$2.03	\$2.25	\$2.50	\$2.78	\$3.10
Share Count (diluted)		500	501	501	501	501	503	506	511	516	518	517	513

<b>Margins</b>													
<b>Gross margin</b>	63.7%	63.5%	64.1%	66.0%	65.0%	64.6%	65.0%	65.5%	65.7%	66.0%	66.5%	67.0%	67.5%
SG&A	38.3%	29.5%	30.4%	31.0%	33.5%	31.2%	29.9%	29.0%	28.1%	27.5%	26.9%	26.3%	25.5%
R&D	13.2%	8.3%	8.2%	9.0%	9.0%	8.6%	8.4%	8.2%	8.0%	7.8%	7.5%	7.4%	7.2%
<b>Operating margin</b>	11.6%	25.3%	25.2%	25.7%	22.2%	24.5%	26.3%	28.1%	29.3%	30.5%	31.8%	33.1%	34.6%
<b>Pretax margin</b>	10.7%	23.1%	22.6%	23.3%	20.5%	22.3%	24.4%	26.5%	28.2%	29.7%	31.3%	32.8%	34.5%
Tax rate	36.5%	29.0%	29.4%	29.5%	29.5%	29.3%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%
<b>Net margin</b>	6.8%	16.4%	16.0%			15.8%	17.3%	18.8%	20.0%	21.1%	22.2%	23.3%	24.5%

<b>Growth Rates</b>													
Revenue		4.1%	1.8%	4.2%	1.0%	2.7%	4.1%	5.5%	6.0%	6.3%	5.9%	5.5%	5.5%
Gross profit		5.0%	0.3%	5.0%	3.1%	3.3%	4.6%	6.3%	6.3%	6.8%	6.7%	6.3%	6.3%
SG&A		-2.7%	-3.4%	-0.3%	-9.5%	-4.4%	0.0%	2.0%	3.0%	4.0%	3.5%	3.0%	2.5%
R&D		-3.2%	0.0%	1.6%	-11.6%	-3.9%	2.0%	2.5%	3.0%	3.5%	3.0%	3.0%	2.5%
Operating income		19.5%	5.2%	14.0%	43.4%	18.7%	11.5%	12.5%	10.7%	10.5%	10.7%	9.8%	10.2%
Pretax income		10.0%	-5.3%	2.1%	39.7%	9.1%	13.7%	14.5%	12.8%	12.2%	11.6%	10.6%	10.8%
Net income		17.8%	1.1%	13.1%	200.7%	30.4%	14.2%	14.5%	12.8%	12.2%	11.6%	10.6%	10.8%
EPS							13.6%	13.9%	11.7%	11.1%	11.1%	10.9%	11.6%

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

## Zoetis: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	FY15E	Income Statement - Quarterly	1Q13A	2Q13A	3Q13E	4Q13E
Revenues	4,336	4,454	4,635	4,890	Revenues	1,090A	1,114A	1,062	1,188
Cost of products sold	(1,549)	(1,575)	(1,622)	(1,687)	Cost of products sold	(398)A	(400)A	(361)	(416)
Gross profit	2,787	2,879	3,013	3,203	Gross profit	692A	714A	701	772
SG&A	(1,452)	(1,388)	(1,388)	(1,416)	SG&A	(322)A	(339)A	(329)	(398)
R&D	(399)	(383)	(391)	(401)	R&D	(90)A	(91)A	(96)	(107)
Operating income	921	1,093	1,219	1,372	Operating income	276A	281A	272	264
Net interest (income) / expense	(31)	(113)	(115)	(103)	Net interest (income) / expense	(22)A	(32)A	(30)	(29)
Other income / (expense)	21	14	25	25	Other income / (expense)	(2)A	3A	5	8
Pretax income	911	994	1,130	1,294	Pretax income	252A	252A	247	243
Income taxes	(372)	(292)	(328)	(375)	Income taxes	(73)A	(74)A	(73)	(72)
Net income - recurring	539	703	802	919	Net income - recurring	179A	178A	174	171
Diluted shares outstanding	0	501	503	506	Diluted shares outstanding	500A	501A	501	501
EPS - excluding non-recurring	-	1.40	1.59	1.82	EPS - excluding non-recurring	0.36A	0.36A	0.35	0.34
EPS - recurring	-	1.40	1.59	1.82	EPS - recurring	0.36A	0.36A	0.35	0.34
Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	FY15E	Ratio Analysis	FY12A	FY13E	FY14E	FY15E
Cash and cash equivalents	317	349	1,123	1,699	Sales growth	2.4%	2.7%	4.1%	5.5%
Short Term Investment	-	-	-	-	EBIT growth	18.4%	18.7%	11.5%	12.5%
Accounts receivable	900	928	927	951	EPS growth - recurring	-	-	13.6%	13.9%
Inventories	1,345	1,094	901	820					
Other current assets	302	302	302	302	Gross margin	64.3%	64.6%	65.0%	65.5%
Current assets	2,864	2,672	3,253	3,772	EBIT margin	21.2%	24.5%	26.3%	28.1%
PP&E	1,241	1,261	1,276	1,276					
Total assets	6,262	6,090	6,686	7,205	Tax rate	40.8%	29.3%	29.0%	29.0%
					Net margin	12.4%	15.8%	17.3%	18.8%
Total debt	582	3,657	3,657	3,407					
Total liabilities	2,221	5,196	5,202	4,961	Return on assets (ROA)	8.6%	11.5%	12.0%	12.7%
Shareholders' equity	4,041	894	1,484	2,244	Return on equity (ROE)	13.3%	78.6%	54.1%	40.9%
Net income (including charges)	436	703	802	919	Free cash flow yield	-	4.5%	6.4%	6.7%
D&A	200	150	120	120					
Change in working capital	(149)	123	200	66					
Other	(33)	28	28	28					
Cash flow from operations	454	784	1,050	1,098					
Capex	(126)	(170)	(135)	(120)					
Free cash flow	349	694	996	1,051					
Cash flow from investing activities	(135)	(170)	(135)	(120)					
Cash flow from financing activities	(78)	(582)	(141)	(402)					

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

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

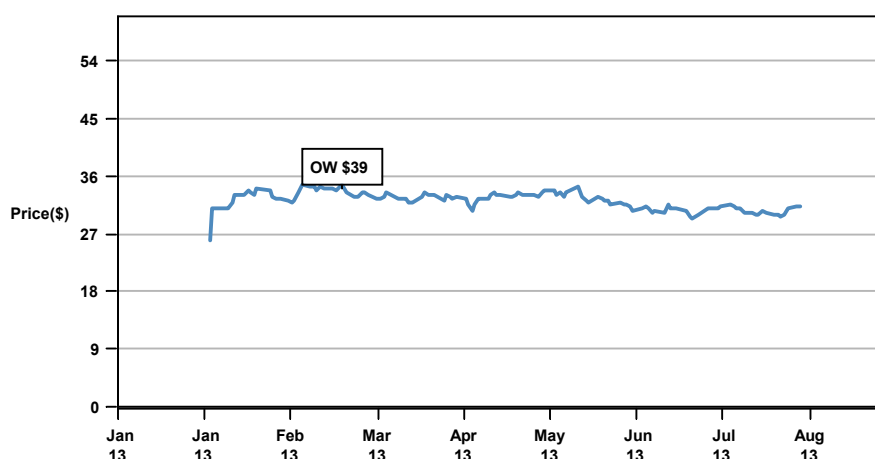
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Zoetis (ZTS, ZTS US) Price Chart



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.

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IB clients*	76%	66%	55%

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