

## Healthcare Services: Alternate Site Providers

### Animal Pharm Update: Potential Industry Consolidation Could Be Good For ZTS

#### CONCLUSION

Bloomberg recently reported that Novartis is in discussions with Merck to trade its animal health and human vaccines businesses for Merck's OTC health products business. While we do not have an opinion on the merits of this potential asset swap, we believe the potential combined animal health business between Merck and Novartis would create a stronger franchise, but it still would not be as large as Overweight-rated ZTS, which remains one of our Top Picks. We believe any potential major consolidation in the animal health industry would lead to some divestitures and attrition, which is a positive for ZTS since the company is in a good position to gain share and buy divested products at attractive valuations. On the other hand, we believe increased consolidation could put some incremental pressure on distributors, including neutral-rated MWIV, HSIC and PDCO over time.

- **Animal health industry consolidation gaining traction, but still waiting for something to happen.** While there has been speculation about consolidation in the animal health industry, Bloomberg recently reported that Novartis is in talks with Merck to trade its animal health and human vaccines businesses for Merck's over-the-counter (OTC) health products business. The article noted that each company would be trading roughly \$5 billion in assets in an effort to focus on core strengths to achieve more size and scale. Media stories have also pointed to Bayer as a potential acquirer of Novartis Animal Health since the company is looking to grow its animal health segment.
- **A Merck/Novartis Animal Health combination would strengthen some product categories, but not without divestitures and attrition.** Based on our industry diligence, a combination between Merck and Novartis' animal health businesses would enhance its competitive position in vaccines, feed additives, and parasiticides. While ZTS is the leader in vaccines, Merck Animal Health is ranked #2 or #3 and we believe Novartis Animal Health is #4 or #5. In feed additives, Elanco (LLY) is the industry leader with ZTS in the second position, Merck #3 and Novartis #4. In parasiticides, Merial (Sanofi) is #1, ZTS is ranked #3, Merck #4. Novartis ran into some manufacturing issues in 2012, which halted production of its popular heartworm and flea medication Sentinel and Interceptor. As with any large acquisition, we believe the potential combination of these two businesses would lead to potential divestitures and customer attrition, which would be beneficial for ZTS and others in the animal health industry.
- **ZTS would maintain its leading position in the industry.** Given the size of a potential merger between Merck and Novartis' animal health businesses, we believe ZTS could benefit by acquiring potentially divested products or gaining share from customer attrition. Assuming 5-15% divestitures and/or attrition, we estimate the combined revenues for Merck/Novartis Animal Health would be ~\$3.9-\$4.3 billion in 2014 which compares to our estimate of \$4.7 billion for ZTS. The bottom-line is while there will likely be some animal health industry consolidation, ZTS will maintain its industry leading share and is in a good position to pick up divested products and gain share from customer attrition. At the 25th annual Piper Jaffray Healthcare conference in early December 2013, ZTS management stated the company has significant experience working with the FTC on large transactions and divestitures and would be interested in acquiring products that were complementary to its portfolio.

#### Kevin K. Ellich

Sr Research Analyst, Piper Jaffray & Co.  
612 303-5666, kevin.k.ellich@pjc.com

#### Bradley D. Maiers

Research Analyst, Piper Jaffray & Co.  
612 303-6646, bradley.d.maiers@pjc.com

Related Companies:	Share Price:
HSIC	117.53
MWIV	178.66
PDCO	41.29
ZTS	31.96

#### RISKS

Risks include regulatory pressures, lower utilization, and increased competition.

*Prices as of the close January 9, 2014.*

**Exhibit 1: Estimated Combined Merck/Novartis Animal Health Revenues vs. Zoetis**

(\$ in MM, except per share)	FY11	FY12	FY13E	FY14E
Merck Animal Health ^	\$3,253	\$3,399	\$3,373	\$3,373
Novartis Animal Health *	\$1,304	\$1,239	\$1,177	\$1,177
<b>Estimated combined revenues</b>	<b>\$4,557</b>	<b>\$4,638</b>	<b>\$4,550</b>	<b>\$4,550</b>
Estimated % divestitures/ attrition on FY14E revs			5%	10%
<b>Estimated FY14 combined revenues</b>			<b>\$4,322</b>	<b>\$4,095</b>
<b>PJC FY14E ZTS revenues</b>				<b>\$4,751</b>

^ Merck Animal Health for FY13 assumes -0.8% decline as Zilmax was taken off the market in August

\* Novartis Animal Health revenues are estimated by PJC and assume a 5% decrease in 2012 and 2013 due to manufacturing issues which have been resolved

Source: Company reports and Piper Jaffray estimates

**Exhibit 2: 2011 Animal Health Rank by Product Category**

	Zoetis	Merck	Meril	Elanco	Bayer	Boehringer- Ingelheim	Novartis	Virbac
2011 Revenues (\$MM)	\$4,233	\$3,253	\$2,823	\$1,679	\$1,649	\$1,357	\$1,304	\$867
<b>Rank by Product Category</b>								
Vaccines	1	3	5			2	4	
Anti-Infectives	1	2	5	4	3			
Feed Additives	2	3		1			4	
Implants	3	1		2				
Parasitocides	3	4	1		5	2		

Source: Company data and Piper Jaffray research

**Ratings, Price Targets, and Risks**

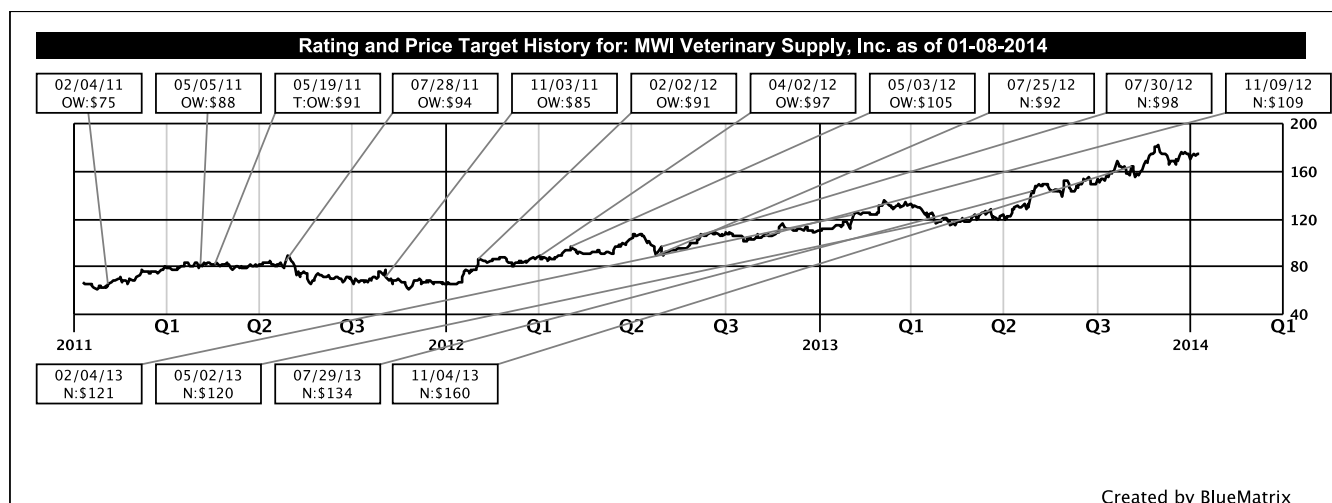
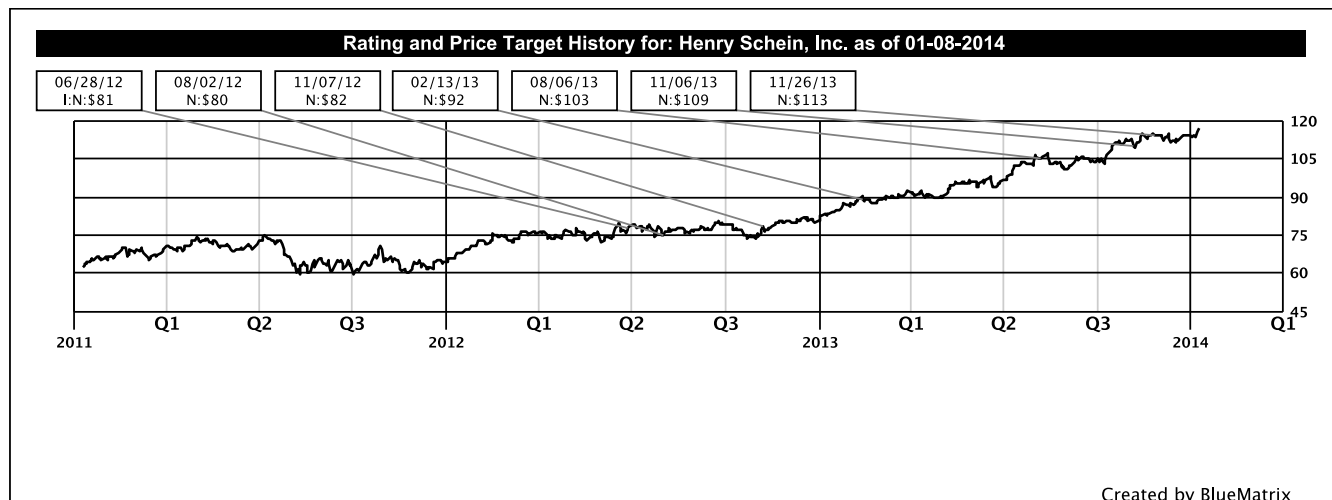
**Henry Schein (HSIC):** Maintain Neutral rating and \$113 PT, based on 21x FY14E EPS. Risks include slowing end markets, acquisition integration, utilization, and competition.

**MWI Veterinary Supply (MWIV):** Maintain Neutral rating and \$160 PT, based on 25x FY15E EPS. Risks include customer concentration, competition and changes in vendor rebates.

**Patterson Companies (PDCO):** Maintain Neutral rating and \$40 PT, based on 17.5x CY14E EPS. Risks include slowing end market growth, increasing competition, changes in purchasing patterns, and increasing shipping costs.

**Zoetis (ZTS):** Maintain Overweight rating and \$39 PT, based on 24.5x FY14E EPS. Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

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N: Neutral  
UW: Underweight  
NA: Not Available  
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			Count	Percent
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**Analyst Certification — Kevin K. Ellich, Sr Research Analyst**

**— Bradley D. Maiers, Research Analyst**

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