

Zoetis

Strong 3Q Top-line Growth; Remain Overweight

Zoetis reported a solid top-line beat with +9% operational growth, supported by strength across all geographies. In our view, these results highlight the company's position as the leader in an attractive animal health space and we see the company poised to generate continued strong growth as weather-related headwinds that have impacted 1H/13 results abate. Despite these results, operating expenses were the focus of today's call as higher promotional spend offset Zoetis' top-line beat. Despite this, we continue to see significant potential operating leverage in the Zoetis model and forecast 100+ bps in annual operating margin expansion for the company over the next 3-5 years. We remain OW ZTS shares.

- **Strong top-line growth encouraging.** Zoetis reported sales of \$1,103mm, representing 9% operational growth over drought-impacted 3Q/12 results. Sales came in above our expectation in every region and were particularly strong in the US and EuAfME. Following mixed 3Q reports from Zoetis' animal health peers, today's results highlight Zoetis' strong position in the market and reinforce our confidence in the company's ability to achieve 5%-6% top-line growth longer-term.
- **We still expect significant operating margin leverage despite higher spend in the quarter.** Third quarter SG&A came in higher than expected at \$359mm (+\$30mn vs. JPMe), due to some timing of spend and as Zoetis invested in promotional programs with the recovery in the market. Importantly, we very much see higher spend as correlated with higher revenue growth and continue to see longer-term leverage in the Zoetis model.
- **Solid 2014 ahead and we are raising our top-line and EPS forecasts.** While we expect operational growth to decelerate next quarter from the 9% seen in 3Q, this is annualizing over a particularly strong 4Q/12 and we continue to expect healthy 4.5% operational growth. Looking ahead to 2014, we expect strong 2014 results (5.5% operational growth) as Zoetis continues to benefit from normalized corn prices in the US and Zoetis faces easy YOY comparisons, particularly in 1H/13. In addition, consistent with this quarter's trends, while we are raising our top-line forecasts, we are also modestly raising our SG&A assumptions for the company.

Overweight

ZTS, ZTS US

Price: \$31.69

Price Target: \$39.00

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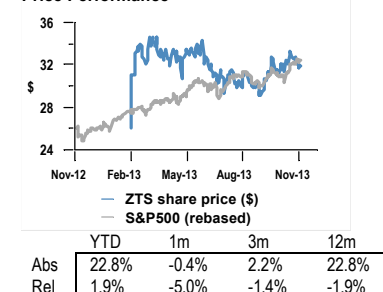
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Price Performance



Zoetis (ZTS;ZTS US)

FYE Dec	2013E (Prev)	2013E (Curr)	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
EPS Reported (\$)						
Q1 (Mar)	0.36A	0.36A	-	-	-	-
Q2 (Jun)	0.36A	0.36A	-	-	-	-
Q3 (Sep)	0.35	0.34A	-	-	-	-
Q4 (Dec)	0.34	0.35	-	-	-	-
FY	1.40	1.41	1.59	1.60	1.82	1.83
CONSENSUS_EPS						
Bloomberg EPS FY (\$)	-	1.40	-	1.61	-	1.81

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

Company Data

Price (\$)	31.69
Date Of Price	05 Nov 13
52-week Range (\$)	35.42-26.00
Market Cap (\$ mn)	15,856.22
Fiscal Year End	Dec
Shares O/S (mn)	500
Price Target (\$)	39.00
Price Target End Date	31-Dec-14

See page 6 for analyst certification and important disclosures.

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Table 1: 3Q/13 Results vs. Estimates

\$ in millions

Zoetis	JPM 3Q13E	Reported 3Q13A	Variance
Total Revenue	\$1,062	\$1,103	\$41
US	\$479	\$495	\$16
EuAfME	\$255	\$270	\$15
CLAR	\$165	\$171	\$6
APAC	\$162	\$167	\$5
Cost of Revenues	\$361	\$383	\$22
Gross Profit	\$701	\$720	\$19
Gross Margin	66.0%	65.3%	-0.7%
SG&A	\$329	\$359	\$30
R&D	\$96	\$91	-\$5
Operating Income	\$272	\$266	-\$6
Operating Margin	25.7%	24.1%	-1.6%
Other Income	\$25	-\$22	-\$47
Tax Rate	29.5%	29.5%	0.0%
Net Income	\$174	\$172	-\$2
EPS	\$0.35	\$0.34	(\$0.01)
Shares	501	500	-0.6

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

Table 2: Changes to EPS and Sales Forecasts

\$ in millions

ZTS Year	EPS			Year	Sales		
	Revised	Previous	Difference		Revised	Previous	Difference
2013E	\$1.41	\$1.40	\$0.01	2013E	\$4,514	\$4,454	\$60
2014E	\$1.60	\$1.59	\$0.01	2014E	\$4,728	\$4,635	\$93
2015E	\$1.83	\$1.82	\$0.01	2015E	\$5,005	\$4,890	\$115
2016E	\$2.05	\$2.03	\$0.02	2016E	\$5,310	\$5,181	\$129
2017E	\$2.27	\$2.25	\$0.01	2017E	\$5,632	\$5,508	\$124
2018E	\$2.50	\$2.50	(\$0.00)	2018E	\$5,944	\$5,836	\$109
2019E	\$2.77	\$2.78	(\$0.01)	2019E	\$6,259	\$6,154	\$105
2020E	\$3.09	\$3.10	(\$0.01)	2020E	\$6,592	\$6,492	\$100

Source: Company reports and 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 19x our 2014 EPS estimate of \$1.59. This represents a 3% 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.

Maintain Dec 2014 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 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		Mar 2013	Jun 2013	Sep 2013	Dec 2013								
Fiscal year ends December 31	FY 2012A	1QA	2QA	3QE	4QE	FY 2013E	FY 2014E	FY 2015E	FY 2016E	FY 2017E	FY 2018E	FY 2019E	FY 2020E
Income Statement													
Revenue													
Total Revenue	4,336	1,090	1,114	1,103	1,207	4,514	4,728	5,005	5,310	5,632	5,944	6,259	6,592
Cost of Revenue	1,549	398	400	383	422	1,603	1,655	1,727	1,821	1,915	1,991	2,065	2,142
Gross Profit	2,787	692	714	720	784	2,910	3,073	3,278	3,488	3,717	3,953	4,193	4,450
Operating Expenses													
SG&A	1,452	322	339	359	398	1,418	1,447	1,490	1,535	1,596	1,652	1,702	1,744
R&D	399	90	91	91	109	381	381	388	400	414	426	439	450
Amortization of intangible assets	15	4	3	4	4	15	15	15	15	15	15	15	15
Total Operating Expenses	1,866	416	433	454	510	1,813	1,842	1,893	1,949	2,024	2,093	2,155	2,209
Income (Loss) from Operations	921	276	281	266	274	1,097	1,231	1,385	1,539	1,692	1,860	2,038	2,241
Other (Income)/Expense	(21)	2	(3)	(7)	(8)	(16)	(20)	(20)	(20)	(20)	(20)	(20)	(20)
Net Interest Expense	31	22	32	29	30	113	115	103	84	65	54	43	32
Total Interest and Other (Income)	10	24	29	22	22	97	95	83	64	45	34	23	12
Income (Loss) Before Income Taxes	911	252	252	244	252	1,000	1,137	1,302	1,475	1,648	1,826	2,016	2,229
Taxes	372	73	74	72	74	293	330	378	428	478	530	585	647
non-controlling interest	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	539	179	178	172	178	707	807	924	1,047	1,170	1,297	1,431	1,583
Adjusted EPS (diluted)		\$ 0.36	\$ 0.36	\$ 0.34	\$ 0.35	\$1.41	\$1.60	\$1.83	\$2.05	\$2.27	\$2.50	\$2.77	\$3.09
Share Count (diluted)		500	501	500	501	501	503	506	511	516	518	517	513

Margins													
Gross margin	64.3%	63.5%	64.1%	65.3%	65.0%	64.5%	65.0%	65.5%	65.7%	66.0%	66.5%	67.0%	67.5%
SG&A	33.5%	29.5%	30.4%	32.5%	33.0%	31.4%	30.6%	29.8%	28.9%	28.3%	27.8%	27.2%	26.5%
R&D	9.2%	8.3%	8.2%	8.3%	9.0%	8.4%	8.1%	7.8%	7.5%	7.3%	7.2%	7.0%	6.8%
Operating margin	21.2%	25.3%	25.2%	24.1%	22.7%	24.3%	26.0%	27.7%	29.0%	30.1%	31.3%	32.6%	34.0%
Pretax margin	21.0%	23.1%	22.6%	22.1%	20.9%	22.2%	24.0%	26.0%	27.8%	29.3%	30.7%	32.2%	33.8%
Tax rate	40.8%	29.0%	29.4%	29.5%	29.5%	29.3%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%	29.0%
Net margin	12.4%	16.4%	16.0%			15.7%	17.1%	18.5%	19.7%	20.8%	21.8%	22.9%	24.0%

Growth Rates													
Revenue	2.4%	4.1%	1.8%	8.2%	2.6%	4.1%	4.7%	5.9%	6.1%	6.1%	5.5%	5.3%	5.3%
Gross profit	5.1%	5.0%	0.3%	7.9%	4.7%	4.4%	5.6%	6.7%	6.4%	6.6%	6.3%	6.1%	6.1%
SG&A	0.3%	-2.7%	-3.4%	8.8%	-9.5%	-2.3%	2.0%	3.0%	3.0%	4.0%	3.5%	3.0%	2.5%
R&D	-2.0%	-3.2%	0.0%	-3.2%	-10.2%	-4.6%	0.0%	2.0%	3.0%	3.5%	3.0%	3.0%	2.5%
Operating income	18.4%	19.5%	5.2%	11.3%	49.0%	19.1%	12.3%	12.5%	11.1%	9.9%	9.9%	9.6%	9.9%
Pretax income	18.3%	10.0%	-5.3%	0.8%	44.8%	9.8%	13.7%	14.5%	13.3%	11.7%	10.9%	10.4%	10.6%
Net income	7.2%	17.8%	1.1%	11.7%	211.6%	31.1%	14.2%	14.5%	13.3%	11.7%	10.9%	10.4%	10.6%
EPS							13.7%	14.0%	12.2%	10.6%	10.4%	10.7%	11.4%

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

Zoetis: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	FY15E	Income Statement - Quarterly	1Q13A	2Q13A	3Q13A	4Q13E
Revenues	4,336	4,514	4,728	5,005	Revenues	1,090A	1,114A	1,103A	1,207
Cost of products sold	(1,549)	(1,603)	(1,655)	(1,727)	Cost of products sold	(398)A	(400)A	(383)A	(422)
Gross profit	2,787	2,910	3,073	3,278	Gross profit	692A	714A	720A	784
SG&A	(1,452)	(1,418)	(1,447)	(1,490)	SG&A	(322)A	(339)A	(359)A	(398)
R&D	(399)	(381)	(381)	(388)	R&D	(90)A	(91)A	(91)A	(109)
Operating income	921	1,097	1,231	1,385	Operating income	276A	281A	266A	274
Net interest (income) / expense	(31)	(113)	(115)	(103)	Net interest (income) / expense	(22)A	(32)A	(29)A	(30)
Other income / (expense)	21	16	20	20	Other income / (expense)	(2)A	3A	7A	8
Pretax income	911	1,000	1,137	1,302	Pretax income	252A	252A	244A	252
Income taxes	(372)	(293)	(330)	(378)	Income taxes	(73)A	(74)A	(72)A	(74)
Net income - recurring	539	707	807	924	Net income - recurring	179A	178A	172A	178
Diluted shares outstanding	0	501	503	506	Diluted shares outstanding	500A	501A	500A	501
EPS - excluding non-recurring	-	1.41	1.60	1.83	EPS - excluding non-recurring	0.36A	0.36A	0.34A	0.35
EPS - recurring	-	1.41	1.60	1.83	EPS - recurring	0.36A	0.36A	0.34A	0.35
Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	FY15E	Ratio Analysis	FY12A	FY13E	FY14E	FY15E
Cash and cash equivalents	317	324	1,100	1,678	Sales growth	2.4%	4.1%	4.7%	5.9%
Short Term Investment	-	-	-	-	EBIT growth	18.4%	19.1%	12.3%	12.5%
Accounts receivable	900	940	946	973	EPS growth - recurring	-	-	13.7%	14.0%
Inventories	1,345	1,113	919	839					
Other current assets	302	302	302	302	Gross margin	64.3%	64.5%	65.0%	65.5%
Current assets	2,864	2,680	3,267	3,792	EBIT margin	21.2%	24.3%	26.0%	27.7%
PP&E	1,241	1,261	1,276	1,276					
Total assets	6,262	6,098	6,700	7,225	Tax rate	40.8%	29.3%	29.0%	29.0%
					Net margin	12.4%	15.7%	17.1%	18.5%
Total debt	582	3,657	3,657	3,407					
Total liabilities	2,221	5,200	5,207	4,967	Return on assets (ROA)	8.6%	11.6%	12.0%	12.8%
Shareholders' equity	4,041	898	1,493	2,259	Return on equity (ROE)	13.3%	78.6%	54.1%	40.9%
Net income (including charges)	436	707	807	924	Free cash flow yield	-	4.2%	6.3%	6.6%
D&A	200	150	120	120					
Change in working capital	(149)	95	196	62					
Other	(33)	28	28	28					
Cash flow from operations	454	759	1,051	1,100					
Capex	(126)	(170)	(135)	(120)					
Free cash flow	349	669	998	1,053					
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

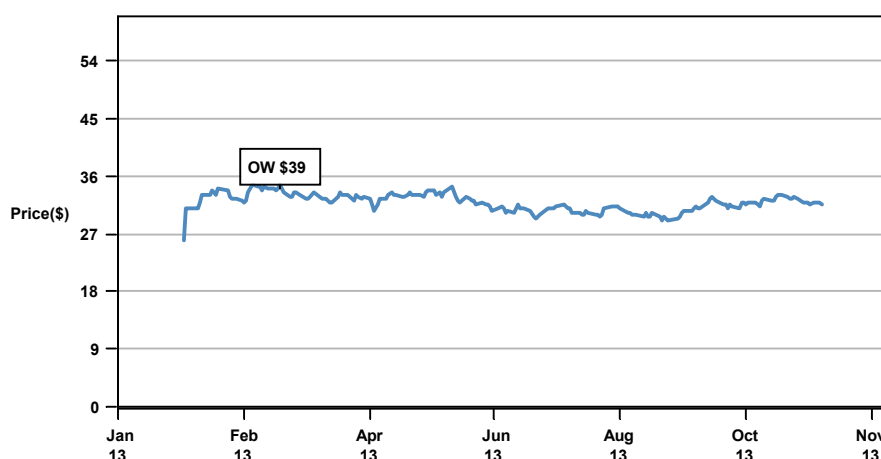
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Zoetis (ZTS, ZTS US) Price Chart



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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