

COMPANY NOTE

Company Update

USA | Healthcare | Pharmaceuticals

April 26, 2013

Jefferies

EQUITY RESEARCH AMERICAS

Zoetis, Inc. (ZTS) Animal Tracker: Read Through To Q1'13 ZTS Results Looks Overdone

Key Takeaway

With many of the key industry constituents (LLY, BAYN, NOVN, VETO, VIRP) having reported Q1'13 results already, we look to find themes that may help interpret Zoetis' upcoming performance. We see the negative read through from some players (LLY in particular) as overdone given company specific factors and low existing expectations for Zoetis.

Leading indicators showing a tough Q1'13 for Animal Health: A number of leading Animal Health players have already reported a mixed set of Q1'13 revenues. This has led to volatility in the share price for Zoetis, which we believe has been overdone to the downside, potentially creating an attractive entry point into the shares.

Production Animals weakness is a known near term issue: It is common knowledge and has already been reported in Zoetis' prior SEC filings that some short term challenges are presenting themselves. In particular, the impact of the drought in North America as well as lower demand/ pricing in Europe has already impacted prior quarters to a degree.

Leading indicators show tough Q1'13; Many impacted by one-offs: Exhibit 1 of this report shows Q1'13 operational revenue growth for the key leading companies that have already reported. The most heavily impacted companies have company specific factors that have adversely affected their growth. For example, Novartis' (NOVN VX, CHF69.40, Buy) Animal Health business is still impacted by manufacturing issues at its Lincoln plant. Virbac (VIRP FP, €145.6, NC) is heavily weighted to Europe (as is Vetoquinol [VETO FP, €27.09, NC]) and faced tough comps due to a successful vaccine launch in Q1'12. Lastly, Eli Lilly's (LLY, \$56.43, U/P) Q1'13 growth was negatively impacted by transition stocking in Q1'12 as part of the Janssen acquisition. Bayer (BAYN GR, €80.70, Hold) reported better growth of 3.4%, but is more heavily weighted into companion animals.

Low expectation = Low chance of missing: We and consensus only expect CER revenue growth for Zoetis of 3% (1% reported - see Exhibit 2). Therefore we see little chance of a significant miss on revenues, given that the companies listed above reported weighted average growth of 1.9% despite the one off headwinds described. We continue to see a good chance of a decent earnings beat (JEFe \$0.37 vs cons. \$0.33) given the strong margin progression trends to date and see the recent weakness as a buying opportunity.

Valuation/Risks

Valuation: Our \$40 PT is derived from PEG/ PE-relative and DCF valuation. **Risks:** Patent expiries; cost saving; legislation; R&D; manufacturing; pricing; weather; epidemics; M&A.

USD	Prev.	2012A	Prev.	2013E	Prev.	2014E	Prev.	2015E
Rev. (B)	--	4.3	--	4.5	--	4.8	--	5.1
EV/Rev		4.3x		4.2x		3.9x		3.7x
EBITDA (B)	--	1.1	--	1.3	--	1.5	--	1.6
EV/EBITDA		17.0x		14.4x		12.5x		11.7x
Dividend	--	0.00	--	0.26	--	0.30	--	0.33
Div. Yield		0.00%		0.82%		0.95%		1.05%
PE Relative to Local Market	193%	185%	158%	151%	149%	142%	151%	144%
EPS								
FY Dec	--	1.08	--	1.42	--	1.68	--	1.83
FY P/E		29.2x		22.2x		18.8x		17.2x

BUY

Price target \$40.00

Price \$31.55

Financial Summary

Net Debt (MM): \$2,905.0

Market Data

52 Week Range: \$35.42 - \$26.00

Total Entprs. Value (MM): \$18,680.0

Market Cap. (MM): \$15,775.0

Shares Out. (MM): 500.0

Float (MM): 99.0

Avg. Daily Vol.: NA

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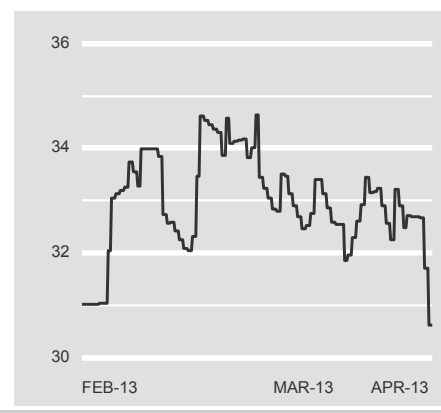
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Price Performance



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Forecast Changes, Financial Models, and Catalysts

Exhibit 1: Comparison of Q1'13 operational sales growth reported to date

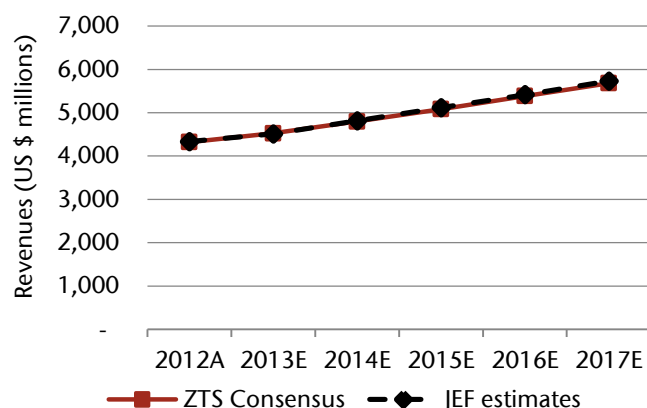
Company	Q1'13 Operational sales growth (% YoY)	Comments
Vetoquinol	-1.0%	Livestock declined 4.2%; Companion Animals grew +0.4%; Americas +0.7%; Asia Pacific +5.6%; EU -3.2% . Heavily weighted in Europe (c60% sales).
Virbac	-2.3%	Companion Animals (c60% sales) declined due to high PY comps in US and EU; Livestock declines due to sluggish EU partially offset by growth in Brazil & India. Heavily weighted in Europe (c60% sales).
Novartis	-2.5%*	Decline due to Lincoln facility manufacturing issues. Excluding Lincoln-related effects grew strongly overall with mid-single digit EU growth and double-digit EM growth. Heavily weighted in companion animals (c65%).
Bayer	3.4%	Growth in tick, flea, and worm control products and US growth; Heavily weighted in companion animals (c60%).
Eli Lilly	2.7%	Lower Food Animal product growth and tough comps from Janssen acquisition transition stocking. Heavily weighted in production animal products (c90%).
Mean (unweighted)	0.1%	
Mean (weighted)	1.9%	

Source: Company Reports, Jefferies

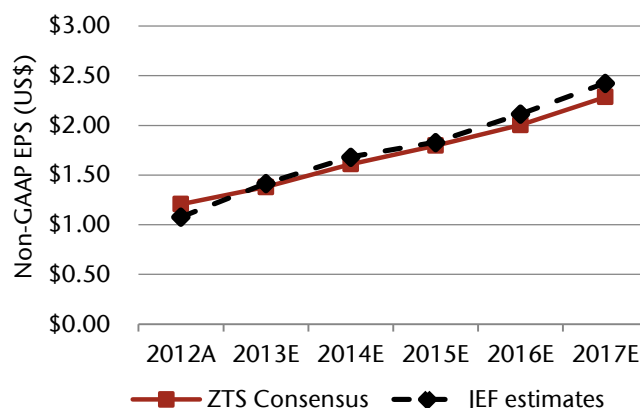
Exhibit 2: Zoetis Q1 2013E key product and income statement variation sheet

(\$) millions	1Q:12A	1Q:13E	YoY %	Cons.	Jefferies Comments on 1Q:13E estimates
US	425	442	4%		
EuAfME	275	271	-1%		
CLAR	173	168	-3%		
APAC	174	179	3%		
Net sales	1,047	1,061	1%	1,079	FX -2%
COGS	388	370	-5%		
Gross profit	659	691	5%	691	
SG&A	323	318	-2%	335	Expect margin expansion
R&D	95	94	-1%	97	Expect R&D spend to be flat
Amortization of intangible assets	4	4	-2%		
Other (income)/Expenses	(6)	(8)	33%		
Total Operating Expenses	416	408	-2%		
Operating Profit	243	283	17%	262	Higher revenues with flat growth in expenses
Net interest (income)/expense	8	17	106%		Higher int. exp. from debt raising in Jan 2013
Pretax Income	235	267	13%	234	
Taxes	79	77	-2%		
Tax rate	33.7%	29.0%	-470bps		Expect lower tax rate compared to previous qtrs.
Net Income/(loss) before non-control. Int.	156	189	22%		
Net income	155	188	22%	170	
DILUTED EPS	\$0.31	\$0.37	21%	\$0.33	Higher revenues and lower tax rate expected
Basic shares outstanding	500	500	0%		
Weighted avg. diluted shares outstanding	500	505	1%		
Dividend per share	na	0.07			
Margin Analysis	1Q:12A	1Q:13E	YoY	Cons.	
COGS	37.1%	34.9%	-218bps	35.9%	
Gross margin	62.9%	65.1%	+218bps	64.1%	
SG&A	30.9%	30.0%	-90bps	30.9%	
R&D	9.1%	8.9%	-20bps	8.9%	
Operating margin	23.2%	26.7%	+348bps	24.3%	
Pretax margin	22.4%	25.1%	+269bps	21.7%	
Net margin	14.8%	17.8%	+296bps	15.5%	

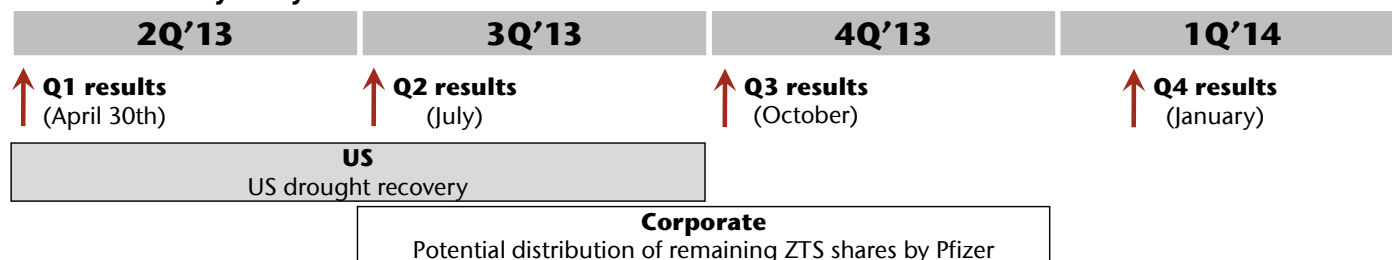
Source: Jefferies estimates

Exhibit 3: Jefferies revenue estimates versus consensus for Zoetis, 2012A-2017E (\$millions)

Source: Thomson One, Jefferies estimates

Exhibit 4: Jefferies EPS estimates versus consensus for Zoetis, 2012A-2017E (\$)

Source: Thomson One, Jefferies estimates

Exhibit 5: Summary catalyst calendar for Zoetis

Source: Jefferies research, company data

Exhibit 6: Key global revenues for Zoetis, 2012A-2017E

(\$) millions	2012A	2013E	2014E	2015E	2016E	2017E	Incr. abs. '12A-'17E	CAGR '12A-'17E
Total Sales	4,336	4,510	4,812	5,117	5,417	5,729	1,393	5.7%
U.S.	1,776	1,861	1,970	2,079	2,183	2,292	516	5.2%
ex-US	2,560	2,649	2,842	3,039	3,234	3,438	878	6.1%
YOY growth (%)	2%	4%	7%	6%	6%	6%		
Underlying growth	6%	4%	7%	6%	6%	6%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	-3%	0%	0%	0%	0%	0%		
US	1,776	1,861	1,970	2,079	2,183	2,292	516	5.2%
YOY growth (%)	7%	5%	6%	6%	5%	5%		
Underlying growth	7%	5%	6%	6%	5%	5%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	0%	0%	0%	0%	0%	0%		
EuAfME	1,096	1,122	1,184	1,243	1,299	1,358	262	4.4%
YOY growth (%)	-4%	2%	5%	5%	4%	4%		
Underlying growth	2%	2%	5%	5%	4%	4%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	-7%	1%	0%	0%	0%	0%		
CLAR	769	799	869	948	1,024	1,100	331	7.4%
YOY growth (%)	-2%	4%	9%	9%	8%	8%		
Underlying growth	4%	4%	9%	9%	8%	8%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	-7%	0%	0%	0%	0%	0%		
APAC	695	727	788	848	911	980	285	7.1%
YOY growth (%)	8%	5%	8%	8%	8%	7%		
Underlying growth	10%	6%	8%	8%	8%	7%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	-2%	-2%	0%	0%	0%	0%		

Source: Jefferies estimates, company data

Exhibit 7: Annual income statement for Zoetis, 2012A-2017E

(\$) millions	2012A	2013E	2014E	2015E	2016E	2017E	Incr. abs. '12A-'17E	CAGR '12A-'17E
Net sales	4,336	4,510	4,812	5,117	5,417	5,729	1,393	5.7%
COGS	1,549	1,574	1,648	1,788	1,871	1,955	406	4.8%
Gross profit	2,787	2,936	3,164	3,329	3,546	3,774	987	6.3%
SG&A	1,450	1,445	1,474	1,533	1,564	1,595	145	1.9%
R&D	399	396	408	424	432	441	42	2.0%
Amortization (Intangible Assets)	15	15	16	15	17	15	(0)	-0.4%
Other (income)/Expenses	(19)	(32)	(32)	(32)	(32)	(32)	(13)	11.0%
Total Operating Expenses	1,845	1,824	1,866	1,940	1,981	2,019	174	1.8%
Operating Profit	942	1,111	1,298	1,389	1,565	1,755	813	13.3%
EBITDA	1,099	1,279	1,468	1,558	1,732	1,917	817	11.8%
Net interest (income)/expense	31	99	106	100	87	72	41	18.4%
Pretax Income	911	1,013	1,193	1,289	1,478	1,683	772	13.1%
Taxes	372	294	340	361	406	454	83	4.1%
Tax rate	40.8%	29.0%	28.5%	28.0%	27.5%	27.0%	(1,380)bps	
NI before non-control. Int.	539	719	853	928	1,072	1,228	689	17.9%
Less: NI attrib to non-control int.	-	4	4	4	4	4	4	
Net income	539	715	849	924	1,068	1,224	685	17.8%
DILUTED EPS	\$1.08	\$1.42	\$1.68	\$1.83	\$2.12	\$2.43	\$1.35	17.6%
Wt. avg. dil. shares outstanding	500	505	505	505	505	505		
Dividend per share	na	0.26	0.30	0.33	0.38	0.44		
Margin Analysis	2012A	2013E	2014E	2015E	2016E	2017E		
COGS	35.7%	34.9%	34.3%	34.9%	34.5%	34.1%		
Gross margin	64.3%	65.1%	65.7%	65.1%	65.5%	65.9%	160 bps	
SG&A	33.4%	32.1%	30.6%	30.0%	28.9%	27.8%	(560)bps	
R&D	9.2%	8.8%	8.5%	8.3%	8.0%	7.7%	(150)bps	
Total Operating Expenses	42.6%	40.5%	38.8%	37.9%	36.6%	35.2%	(731)bps	
Operating margin	21.7%	24.6%	27.0%	27.1%	28.9%	30.6%	892 bps	
EBITDA margin	25.4%	28.4%	30.5%	30.4%	32.0%	33.5%	810 bps	
Pretax margin	21.0%	22.5%	24.8%	25.2%	27.3%	29.4%	837 bps	
Net margin	12.4%	15.9%	17.6%	18.1%	19.7%	21.4%	894 bps	
Dividend Payout ratio	na	18.3%	18.0%	18.0%	18.0%	18.0%		
YOY % Change	2012A	2013E	2014E	2015E	2016E	2017E		
Net sales	2%	4%	7%	6%	6%	6%		
COGS	-2%	2%	5%	8%	5%	5%		
Gross profit	5%	5%	8%	5%	7%	6%		
SG&A	0%	0%	2%	4%	2%	2%		
R&D	-2%	-1%	3%	4%	2%	2%		
Operating income	17%	18%	17%	7%	13%	12%		
EBITDA	na	16%	15%	6%	11%	11%		
Pretax income	18%	11%	18%	8%	15%	14%		
Net income	7%	33%	19%	9%	16%	15%		
Diluted EPS	7%	31%	19%	9%	16%	15%		
Wt. Avg. dil. shares outstanding	0%	1%	0%	0%	0%	0%		

Source: Jefferies estimates, company data

Exhibit 8: Summary Balance Sheet for Zoetis, 2012A-2017E

(\$ millions)	2012A	2013E	2014E	2015E	2016E	2017E
Cash and short-term investments	317	635	1,193	1,826	2,331	2,963
Cash and cash equivalents	317	635	1,193	1,826	2,331	2,963
Short-term investments	-	-	-	-	-	-
Accounts receivable	900	988	1,061	1,129	1,196	1,265
Inventories	1,345	1,381	1,455	1,579	1,653	1,728
Other current assets	302	302	302	302	302	302
Prepaid expenses and taxes	101	101	101	101	101	101
Other	201	201	201	201	201	201
Current assets	2,864	3,306	4,010	4,837	5,481	6,257
Net PPE	1,241	1,259	1,275	1,241	1,211	1,184
Goodwill and intangible items	1,853	1,791	1,728	1,668	1,609	1,554
Other non-current assets	304	304	304	304	304	304
Total Assets	6,262	6,660	7,317	8,050	8,605	9,300
Short-term debt	73	-	-	-	-	-
Payables and accrued expenses	543	541	561	591	616	642
Accounts payable	319	307	318	344	360	376
Income taxes payable	30	40	49	53	62	72
Accrued comp. and rel. items	194	194	194	194	194	194
Other current liabilities	507	507	507	507	507	507
Current liabilities	1,123	1,048	1,068	1,098	1,123	1,149
Long-term debt	509	3,540	3,540	3,440	3,040	2,640
Other non-current liabilities	589	589	589	589	589	589
Deferred taxes and credits	323	323	323	323	323	323
Other	266	266	266	266	266	266
Total Liabilities	2,221	5,177	5,197	5,127	4,752	4,378
Preferred stock (carrying value)	-	-	-	-	-	-
Business unit equity	4,183	-	-	-	-	-
Equity attrib. to non-control. Int.	15	15	15	15	15	15
Common equity	(157)	1,468	2,106	2,908	3,838	4,907
Retained earnings	-	419	1,057	1,859	2,789	3,858
Other comprehensive	(157)	(157)	(157)	(157)	(157)	(157)
Shareholders' Equity	4,041	1,483	2,121	2,923	3,853	4,922
Total Liabilities and Equity	6,262	6,660	7,317	8,050	8,605	9,300
Net Debt	265	2,905	2,347	1,614	709	(323)

Source: Jefferies estimates, company data

Exhibit 9: Summary Cash Flow Statement for Zoetis, 2012A-2017E

(\$ millions)	2012A	2013E	2014E	2015E	2016E	2017E
Pro forma net income	539	715	849	924	1,068	1,224
Adj. for excluded gains (charges)	(103)	(215)	(116)	(15)	(17)	(15)
Net income (GAAP)	436	500	733	909	1,051	1,209
Adj. to reconcile NI before noncontrol int.	167	254	257	254	250	241
Depreciation and amortization	200	214	217	214	210	201
Depreciation	142	152	154	154	150	147
Amortization (purchase accounting)	53	47	47	45	43	39
Share-based compensation expense	28	40	40	40	40	40
Asset write-offs and impairments	10	-	-	-	-	-
Net gains on sales of assets	-	-	-	-	-	-
Deferred taxes	(74)	-	-	-	-	-
Other non-cash adjustments	3	-	-	-	-	-
Change in assets & liab., net of acq & divest.	(149)	(126)	(126)	(163)	(115)	(118)
Net cash from operating activities	454	628	864	1,000	1,186	1,332
Capital expenditures	(123)	(170)	(170)	(120)	(120)	(120)
Other	(12)	-	-	-	-	-
Net cash from investing activities	(135)	(170)	(170)	(120)	(120)	(120)
Net change in short-term debt	-	(73)	-	-	-	-
Net change in long-term debt	-	3,031	-	(100)	(400)	(400)
Cash dividends paid	(63)	(121)	(136)	(146)	(161)	(180)
Net common stock transactions	-	(2,977)	-	-	-	-
Net financing activities with Pfizer	(15)	(2,982)	-	-	-	-
Net cash from financing activities	(78)	(140)	(136)	(246)	(561)	(580)
Effect of exchange rates	(3)	-	-	-	-	-
Net increase in cash	238	318	558	633	505	632
Cash at beginning of period	79	317	635	1,193	1,826	2,331
Cash at end of period	317	635	1,193	1,826	2,331	2,963

Source: Jefferies estimates, company data

Company Description

Zoetis, Inc. is a global leader in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on both livestock and companion animals. Zoetis represents the largest animal health business in the world, with over \$4.2Bn in revenue in 2011.

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risk, growth rate, revenue stream, discounted cash flow (DCF), EBITDA, EPS, cash flow (CF), free cash flow (FCF), EV/EBITDA, P/E, PE/growth, P/CF, P/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

Conviction List Methodology

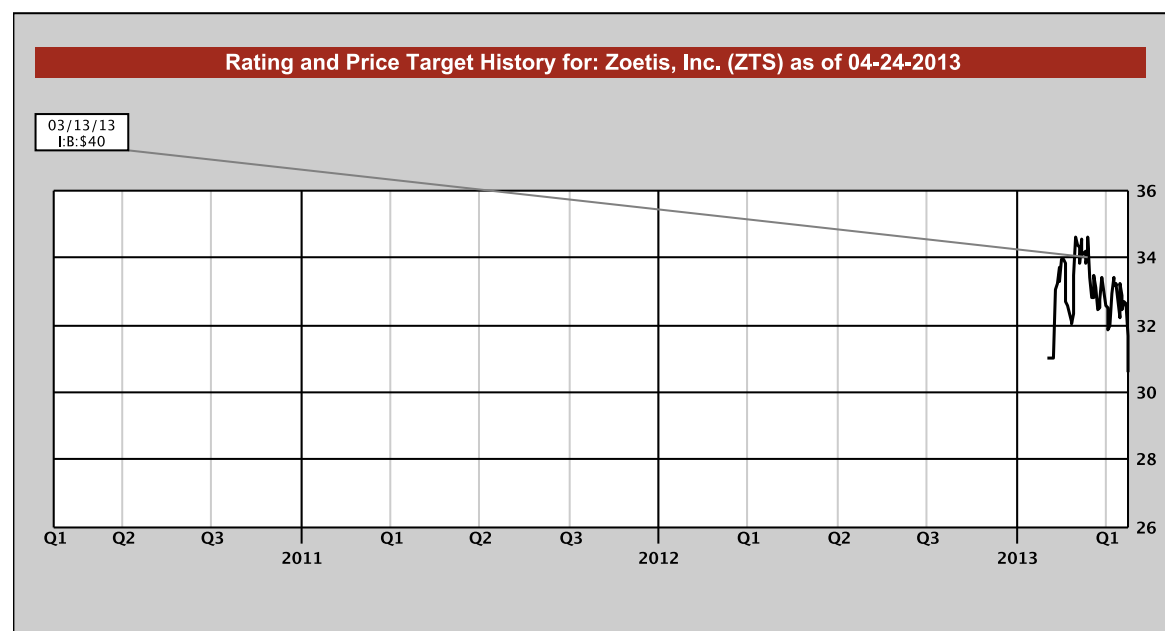
1. The aim of the conviction list is to publicise the best individual stock ideas from Jefferies Global Research
2. Only stocks with a Buy or Underperform rating are allowed to be included in the recommended list.
3. Stocks are screened for minimum market capitalisation and adequate daily turnover. Furthermore, a valuation, correlation and style screen is used to ensure a well-diversified portfolio.
4. Stocks are sorted to a maximum of 30 stocks with the maximum country exposure at around 50%. Limits are also imposed on a sector basis.
5. Once a month, analysts are invited to recommend their best ideas. Analysts' stock selection can be based on one or more of the following: non-Consensus investment view, difference in earnings relative to Consensus, valuation methodology, target upside/downside % relative to the current stock price. These are then assessed against existing holdings to ensure consistency. Stocks that have either reached their target price, been downgraded over the course of the month or where a more suitable candidate has been found are removed.
6. All stocks are inserted at the last closing price and removed at the last closing price. There are no changes to the conviction list during the month.
7. Performance is calculated in US dollars on an equally weighted basis and is compared to MSCI World AC US\$.
8. The conviction list is published once a month whilst global equity markets are closed.
9. Transaction fees are not included.
10. All corporate actions are taken into account.

Risk which may impede the achievement of our Price Target

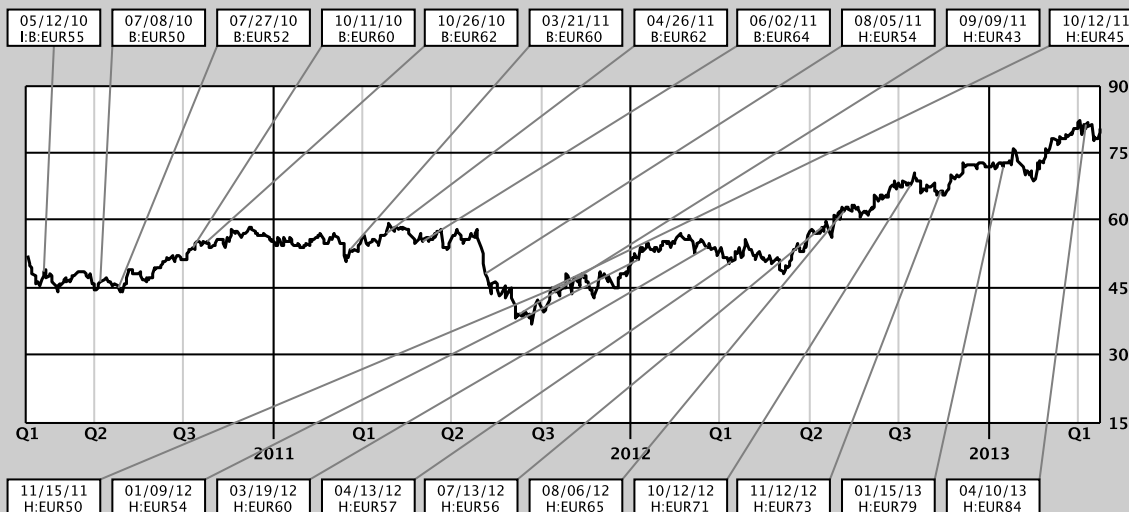
This report was prepared for general circulation and does not provide investment recommendations specific to individual investors. As such, the financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions based upon their specific investment objectives and financial situation utilizing their own financial advisors as they deem necessary. Past performance of the financial instruments recommended in this report should not be taken as an indication or guarantee of future results. The price, value of, and income from, any of the financial instruments mentioned in this report can rise as well as fall and may be affected by changes in economic, financial and political factors. If a financial instrument is denominated in a currency other than the investor's home currency, a change in exchange rates may adversely affect the price of, value of, or income derived from the financial instrument described in this report. In addition, investors in securities such as ADRs, whose values are affected by the currency of the underlying security, effectively assume currency risk.

Other Companies Mentioned in This Report

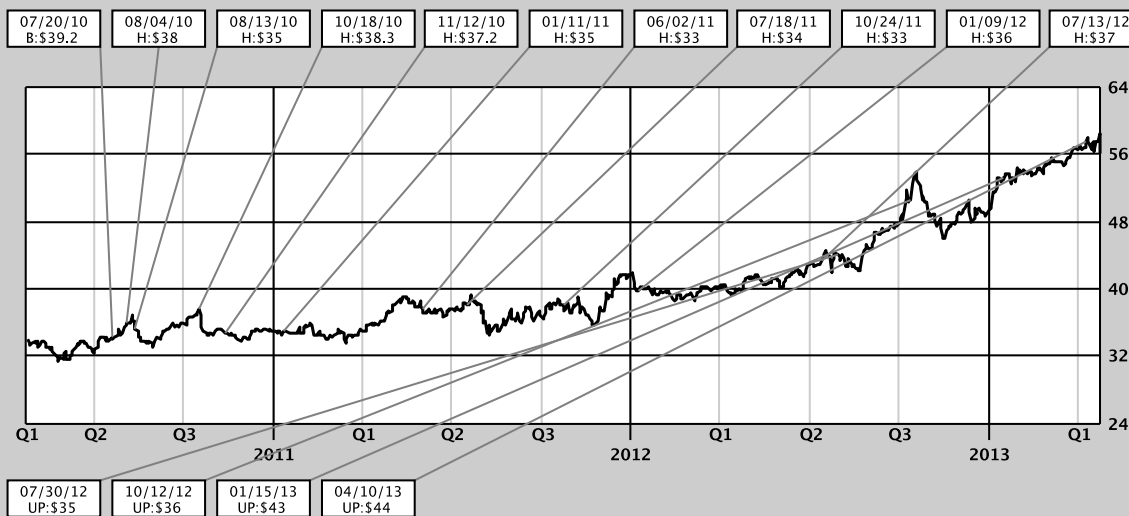
- Bayer AG (BAYN GR: €80.66, HOLD)
- Eli Lilly & Co. (LLY: \$56.43, UNDERPERFORM)
- Novartis AG (NOVN VX: CHF69.40, BUY)

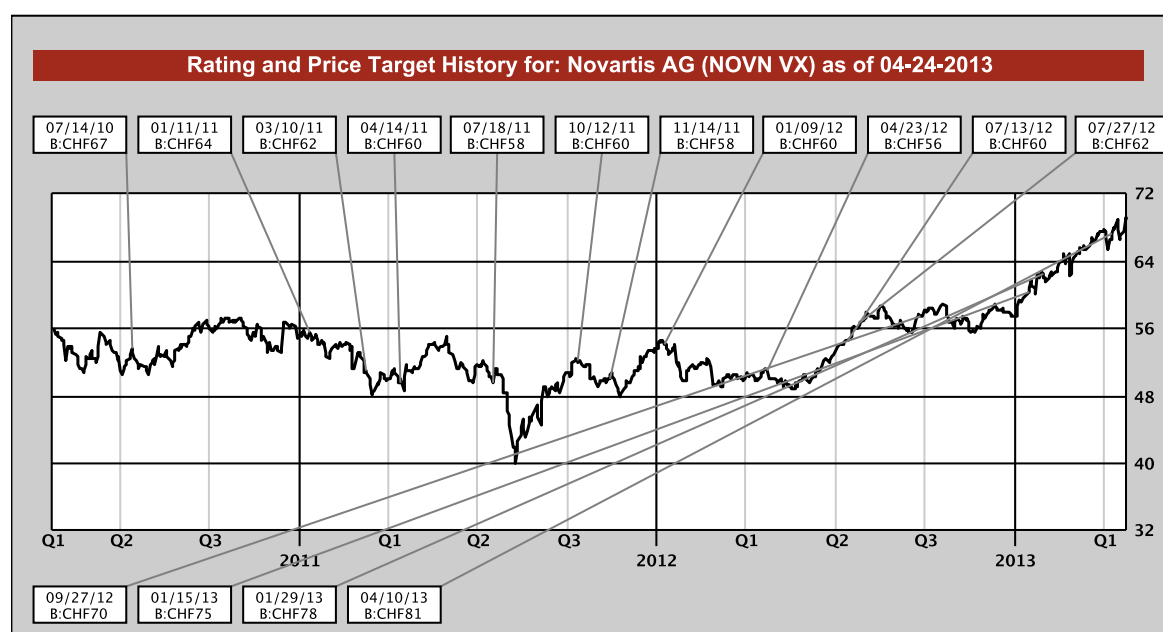


Rating and Price Target History for: Bayer AG (BAYN GR) as of 04-24-2013



Rating and Price Target History for: Eli Lilly & Co. (LLY) as of 04-24-2013





Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY	760	46.68%	126	16.58%
HOLD	736	45.21%	88	11.96%
UNDERPERFORM	132	8.11%	2	1.52%

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