

Tuesday, March 12, 2013

Zoetis (Underperform)

(ZTS-NYSE)

Increased Scrutiny of Livestock Antibiotics Use in China Is Incrementally Negative

Flash:

Yesterday, Yum! Brands (YUM, Not Rated), stated that it is “in the process of incorporating all of the Shanghai FDA’s (SFDA) recommendations” regarding improving the quality of the poultry supply management at Yum! China. The company’s China KFC sales have been significantly impacted by the intense negative media attention surrounding an investigation that showed that a few Chinese poultry farmers were ignoring laws and regulations by using excessive levels of antibiotics in chicken, which was purchased by suppliers of KFC China.

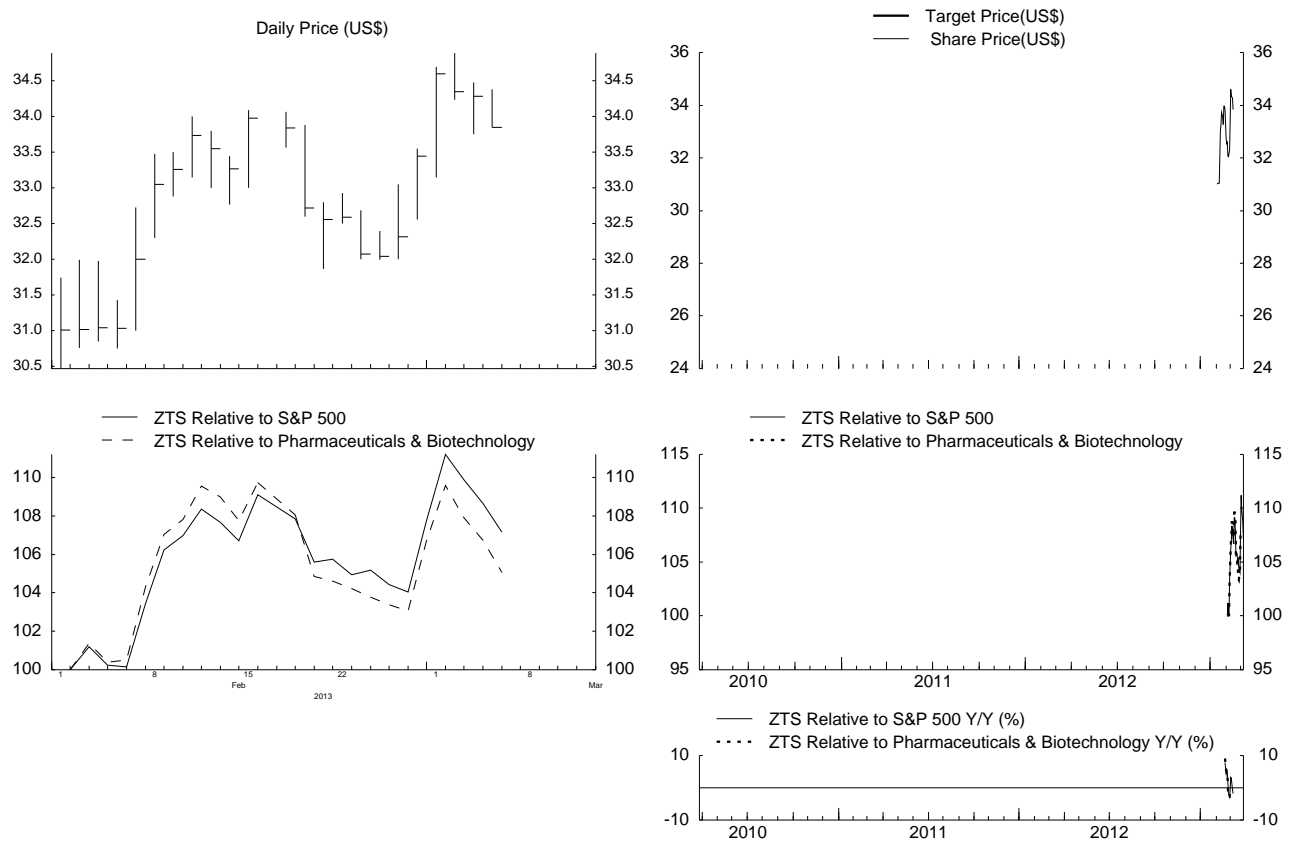
Our View:

- * Increased scrutiny of livestock supply chain practices in China could dampen the strong growth of Zoetis’ Asia Pacific (APAC) segment, which includes China, India, Australia, Japan, New Zealand, and South Korea. APAC accounts for roughly 15%-16% of Zoetis’ revenues, and we forecast strong high single-digit growth in this segment driven by both Livestock and Companion Animal products. More broadly, antibacterials for livestock account for roughly 27% of Zoetis’ revenues, and the key concern is that there could be increased restrictions against the use of antibiotics in livestock, escalating what we’ve already seen in the US and Western Europe markets. Overall, we forecast that Zoetis’ livestock business can grow at an 11-year CAGR of 4.6%, driven by products for swine and poultry. However, additional regulatory restrictions could slow down growth.
- * We maintain our Underperform rating on ZTS shares. Although, we recognize that Zoetis is a unique healthcare growth story with therapeutic and geographically diversified revenues and strong fundamental growth drivers (i.e., growing global demand for animal protein and pet ownership, particularly in emerging markets), we argue that the stock is overvalued at current levels. However, there is some upside to our valuation of \$28 per share if the company’s effective tax rate comes down below our current conservative expectation of 33%-34%. Based on our current forecasts, a gradual lowering of the tax rate to 30% by 2016-2017 could bring our price target up to \$30, still 12% below current levels.

Company:	Zoetis (ZTS)
Price/Rating/Target:	\$34.18/Underperform/\$28.00
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This report was prepared by an analyst(s) employed by BMO Nesbitt Burns Inc. For disclosure statements, including the Analyst’s Certification, please refer to pages 2 to 5.

ZOETIS INC (ZTS)



ZTS - Rating as of 28-Jan-13 = NR

Last Daily Data Point: March 6, 2013

Important Disclosures

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Company Specific Disclosure

Methodology and Risks to Our Price Target

Methodology: DCF and P/E Multiple

Risks: Demand for animal health products could fluctuate and there are relatively low barriers to entry for competitors.

Distribution of Ratings (December 31, 2012)

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
Buy	Outperform	37.0%	17.7%	52.9%	38.5%	50.5%	54.0%
Hold	Market Perform	60.7%	9.6%	47.1%	57.3%	48.4%	40.6%
Sell	Underperform	2.4%	0.0%	0.0%	4.2%	1.0%	5.4%

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OP = Outperform - Forecast to outperform the market;

Mkt = Market Perform - Forecast to perform roughly in line with the market;

Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;

NR = No rating at this time;

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