

Morgan Stanley & Co. LLC

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Stock Rating  
Equal-weight

Industry View  
In-Line

April 1, 2013

## Zoetis Inc.

### 4Q EPS below due to abnormal SG&A and tax

**4Q EPS of \$0.11 were 60% below our \$0.28 and 58% below cons' \$0.27.** Relative to our model, higher than expected gross profit (+0.01) was offset by higher than expected SG&A (-\$0.03) and a significantly higher than expected tax rate (-\$0.15). **See variance on pp. 2-5.**

**4Q revenues of \$1.18B were 1% below our \$1.19B and 1% above cons' \$1.17B.** 4Q constant-currency organic growth of +7% YOY compared to Pfizer-reported animal health c.c. organic growth of +8%. For the full year, ZTS reported c.c. organic growth of +5%. Higher-than-expected organic growth in 4Q (+7% YOY) offset lower-than-expected organic growth in 3Q (+3% YOY) due primarily to the timing of livestock-related herd management decisions.

**Gross margins encouraging; SG&A includes some non-recurring stand-up costs.** 4Q gross margin of 63.7% was 170 b.p. above our 62% and 70 b.p. above cons' 63%. 4Q SG&A of \$441M was 4% above our \$400M. Note higher-than-expected SG&A included some additional costs associated with the build-up of ZTS' stand-alone infrastructure.

**4Q tax rate appears to be an anomaly.** 4Q tax rate of 67.5% was above our 33% est. According to the 10K, the 4Q tax rate includes "tax costs related to uncertain tax positions, substantially all of which will remain with PFE, and to a lesser extent, tax costs associated with repatriation decisions among other impacts."

**Mgmt. expects a lower tax rate on a go-forward basis.** 10K notes: "Throughout 2012, we have undertaken a number of internal reorganization steps designed to improve our operational efficiency and reduce costs... As a result of these items, which will change our jurisdictional mix of earnings, among other impacts, we expect that our future effective tax rate on adjusted pretax income will be lower than historical levels." **We model a 29% T.R. in 2013E and beyond.**

**We look forward to detailed 2013 financial guidance on the Apr. 30 conference call.**

#### Key Ratios and Statistics

Reuters: ZTS.N Bloomberg: ZTS US

Specialty Pharmaceuticals / United States of America

|                                 |               |
|---------------------------------|---------------|
| Shr price, close (Mar 28, 2013) | \$33.40       |
| Mkt cap, curr (mm)              | \$16,700      |
| 52-Week Range                   | \$35.40-30.50 |

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April 1, 2013

Zoetis Inc.

## ZTS disclosed full-year results, and we backed out 4Q.

Adjustments are on pp. 47-51 of the 10K.

Exhibit 1

### ZTS 4Q:12 Income Statement Variation (YOY)

|   | Actual |            | MS Estimate |            | Variation vs. MS Est. |        |            | CONS. est. | Variation vs. CONS. |        | Actual  |
|---|--------|------------|-------------|------------|-----------------------|--------|------------|------------|---------------------|--------|---------|
| (\$M)   | 4Q:12A | YOY % Chg. | 4Q:12E      | YOY % Chg. | Absolute              | Pct    | EPS Impact | 4Q:12E     | Absolute            | Pct    | 4Q:11A  |
| Net revenues                                    | 1,176  | 4%         | 1,192       | 6%         | (15)                  | -1%    | -0.01      | 1,168      | 8                   | 1%     | 1,127   |
| COGS  | 427    | 8%         | 453         | 14%        | (26)                  | -6%    | +0.02      |            |                     |        | 396     |
| Gross profit                                    | 749    | 3%         | 739         | 1%         | 11                    | 1%     | +0.01      | 735        | 14                  | 2%     | 731     |
| SG&A  | 441    | 4%         | 400         | -6%        | 41                    | 10%    | -0.03      |            |                     |        | 424     |
| R&D   | 121    | 10%        | 118         | 7%         | 3                     | 3%     | -0.00      |            |                     |        | 110     |
| Amortization of intangibles                     | 4      | -33%       | 6           | 0%         | (2)                   | -33%   | +0.00      |            |                     |        | 6       |
| Operating income                                | 183    | -4%        | 215         | 12%        | (31)                  | -15%   | -0.02      | 208        | (25)                | -12%   | 191     |
| Other expenses/(income)                         | 10     | N.M.       | 4           | -500%      | 6                     | 150%   | +0.00      |            |                     |        | (1)     |
| Interest expense                                | 8      | -11%       | 7           | -22%       | 1                     | 14%    |            |            |                     |        | 9       |
| Other expense (income)                          | 2      | -120%      | (3)         | -70%       | 5                     | -167%  |            |            |                     |        | (10)    |
| Pretax income                                   | 173    | -10%       | 211         | 10%        | (37)                  | -18%   | -0.02      | 202        | (29)                | -14%   | 192     |
| Taxes   | 117    | 70%        | 70          | 1%         | 47                    | 68%    | -0.15      |            |                     |        | 69      |
| Tax Rate  | 67.5%  | 88%        | 33.0%       | -8%        | 34.5%                 | 104%   |            |            |                     |        | 35.9%   |
| Income attributable to non-controlling interest | -      | -100%      | -           | -100%      | -                     | *      | +0.00      |            |                     |        | 1       |
| Net income (Non-GAAP)                           | 56     | -54%       | 141         | 16%        | (85)                  | -60%   | -0.17      | 134        | (78)                | -58%   | 122     |
| DILUTED EPS, proforma                           | \$0.11 | -54%       | \$ 0.28     | 16%        | (\$0.17)              | -60.0% |            | \$0.27     | (\$0.15)            | -57.6% | \$ 0.24 |
| Diluted shares outstanding                      | 500    | 0%         | 500         | 0%         | -                     | 0%     |            |            |                     |        | 500     |

\*\$0.01 per share equates to approximately \$15.4M pretax

| Margin Analysis  | Actual |  | MS Estimate |  | Variation (b.p.) |            | CONS.  |                  |      | Actual |
|------------------|--------|--|-------------|--|------------------|------------|--------|------------------|------|--------|
|                  | 4Q:12A |  | 4Q:12E      |  | vs. MS est.      | vs. 4Q:11A | 4Q:12E | Variation (b.p.) |      | 4Q:11A |
| COGS             | 36.3%  |  | 38.0%       |  | (170)            | 116        |        |                  |      | 35.1%  |
| Gross margin     | 63.7%  |  | 62.0%       |  | 170              | (116)      | 63.0%  | 74               | 1%   | 64.9%  |
| SG&A             | 37.5%  |  | 33.6%       |  | 392              | (14)       |        |                  |      | 37.6%  |
| R&D              | 10.3%  |  | 9.9%        |  | 38               | 53         |        |                  |      | 9.8%   |
| Operating margin | 15.6%  |  | 18.0%       |  | (243)            | (136)      | 17.8%  | (225)            | -13% | 16.9%  |
| Pretax margin    | 14.7%  |  | 17.7%       |  | (295)            | (230)      | 17.3%  | (257)            | -15% | 17.0%  |
| Net margin       | 4.8%   |  | 11.9%       |  | (705)            | (603)      | 11.5%  | (669)            | -58% | 10.8%  |

Source: Company Data, Morgan Stanley Research

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Zoetis Inc.

Exhibit 2

**Zoetis 4Q:12 Revenue Variation (annual)**

| (\$M)                              | Actual       |            | MS Estimate  |            | Variation vs. MS Est. |            | CONS. est. | Variation vs. Cons. |     | Actual       |
|------------------------------------|--------------|------------|--------------|------------|-----------------------|------------|------------|---------------------|-----|--------------|
|                                    | 4Q:12A       | YOY % Chg. | 4Q:12E       | YOY % Chg. | Absolute              | Pct        | 4Q:12E     | Absolute            | Pct | 4Q:11A       |
| United States (U.S.)               | 483          | 7%         | 471          | 5%         | 11                    | 2%         |            |                     |     | 449          |
| Base revenue                       | 483          | *          | 471          | *          | 11                    | 2%         |            |                     |     | -            |
| Acquisitions                       | -            | *          | -            | *          | -                     | *          |            |                     |     | -            |
| Europe/Africa/Middle East (EuAfME) | 297          | 1%         | 296          | 1%         | 1                     | 0%         |            |                     |     | 293          |
| Base revenue                       | 311          | *          | 308          | *          | 3                     | 1%         |            |                     |     | -            |
| Fx impact                          | (14)         | *          | (12)         | *          | (2)                   | N.M.       |            |                     |     | -            |
| Acquisitions                       | -            | *          | -            | *          | -                     | *          |            |                     |     | -            |
| Canada/Latin America (CLAR)        | 220          | -1%        | 240          | 8%         | (20)                  | -8%        |            |                     |     | 223          |
| Base revenue                       | 233          | *          | 250          | *          | (17)                  | -7%        |            |                     |     | -            |
| Fx impact                          | (13)         | *          | (10)         | *          | (3)                   | N.M.       |            |                     |     | -            |
| Acquisitions                       | -            | *          | -            | *          | -                     | *          |            |                     |     | -            |
| Asia Pacific (APAC)                | 177          | 9%         | 185          | 14%        | (8)                   | -4%        |            |                     |     | 162          |
| Base revenue                       | 177          | *          | 185          | *          | (8)                   | -4%        |            |                     |     | -            |
| Fx impact                          | 1            | *          | -            | *          | 1                     | *          |            |                     |     | -            |
| Acquisitions                       | -            | *          | -            | *          | -                     | *          |            |                     |     | -            |
| <b>Total Revenue</b>               | <b>1,176</b> | <b>4%</b>  | <b>1,192</b> | <b>6%</b>  | <b>(15)</b>           | <b>-1%</b> |            |                     |     | <b>1,127</b> |
| Base revenue                       | 1,203        | 7%         | 1,214        |            | (10)                  | -1%        |            |                     |     |              |
| Fx impact                          | (27)         |            | (22)         |            | (5)                   | N.M.       |            |                     |     |              |
| Acquisitions                       | -            |            |              |            |                       |            |            |                     |     |              |

Source: Company Data, Morgan Stanley Research

Exhibit 3

**Zoetis 4Q:12 Income Statement Variation (sequential)**

| (\$M)   | Reported       | Sequential Growth |             | Actual         |
|---|----------------|-------------------|-------------|----------------|
|   | 4Q:12A         | Dollar            | % Chg.      | 3Q:12A         |
| Net revenues                                    | 1,176          | 158               | 16%         | 1,018          |
| COGS  | 427            | 75                | 21%         | 352            |
| Gross profit                                    | 749            | 83                | 12%         | 666            |
| SG&A  | 441            | 111               | 34%         | 330            |
| R&D   | 121            | 27                | 29%         | 94             |
| Amortization of intangibles                     | 4              | -                 | 0%          | 4              |
| Operating income                                | 183            | (55)              | -23%        | 238            |
| Other expenses/(income)                         | 10             | 13                | -433%       | (3)            |
| Interest expense                                | 8              | 1                 | 14%         | 7              |
| Other expense (income)                          | 2              | 12                | -120%       | (10)           |
| Pretax income                                   | 173            | (68)              | -28%        | 241            |
| Taxes   | 117            | 28                | 31%         | 89             |
| Tax Rate  | 67.5%          | 0                 | 83%         | 36.9%          |
| Income attributable to non-controlling interest | -              | 1                 | -100%       | (1)            |
| Net income (Non-GAAP)                           | 56             | (97)              | -63%        | 153            |
| <b>DILUTED EPS, proforma</b>                    | <b>\$ 0.11</b> | <b>(\$0.19)</b>   | <b>-63%</b> | <b>\$ 0.31</b> |
| Diluted shares outstanding                      | 500            | -                 | 0%          | 500            |

| Margin Analysis  | Reported | Variation       | Actual |
|------------------|----------|-----------------|--------|
|                  | 4Q:12A   | b.p. difference | 3Q:12A |
| COGS             | 36.3%    | 173             | 34.6%  |
| Gross margin     | 63.7%    | -173            | 65.4%  |
| SG&A             | 37.5%    | 508             | 32.4%  |
| R&D              | 10.3%    | 106             | 9.2%   |
| Operating margin | 15.6%    | -782            | 23.4%  |
| Pretax margin    | 14.7%    | -897            | 23.7%  |
| Net margin       | 4.8%     | -1027           | 15.1%  |

Source: Company Data, Morgan Stanley Research

Exhibit 4

**Zoetis 4Q:12 Revenue Variation (sequential)**

| (\$M)                                     | Reported     | Sequential Growth |            | Actual       |
|---|--------------|-------------------|------------|--------------|
|   | 4Q:12A       | Dollar            | % Chg.     | 3Q:12A       |
| <b>United States (U.S.)</b>               | 483          | 35                | 8%         | 448          |
| Base revenue                              | 483          | 35                | 8%         | 448          |
| Acquisitions                              | -            | -                 | *          | -            |
| <b>Europe/Africa/Middle East (EuAfME)</b> | 297          | 56                | 23%        | 241          |
| Base revenue                              | 483          | 211               | 77%        | 272          |
| Fx impact                                 | (14)         | 17                | N.M.       | (31)         |
| Acquisitions                              | -            | -                 | *          | -            |
| <b>Canada/Latin America (CLAR)</b>        | 220          | 54                | 33%        | 165          |
| Base revenue                              | 483          | 295               | 157%       | 188          |
| Fx impact                                 | (14)         | 9                 | N.M.       | (23)         |
| Acquisitions                              | -            | -                 | *          | -            |
| <b>Asia Pacific (APAC)</b>                | 177          | 12                | 8%         | 165          |
| Base revenue                              | 483          | 310               | 179%       | 173          |
| Fx impact                                 | (14)         | (6)               | N.M.       | (8)          |
| Acquisitions                              | -            | -                 | *          | -            |
| <b>Total Revenue</b>                      | <b>1,176</b> | <b>158</b>        | <b>16%</b> | <b>1,018</b> |

Source: Company Data, Morgan Stanley Research

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Zoetis Inc.



**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of March 31, 2013)

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weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

| Stock Rating Category    | Coverage Universe |            | Investment Banking Clients (IBC) |                |                      |
|--------------------------|-------------------|------------|----------------------------------|----------------|----------------------|
|                          | Count             | % of Total | Count                            | % of Total IBC | % of Rating Category |
| <b>Overweight/Buy</b>    | <b>1031</b>       | <b>36%</b> | <b>402</b>                       | <b>39%</b>     | <b>39%</b>           |
| <b>Equal-weight/Hold</b> | <b>1250</b>       | <b>44%</b> | <b>480</b>                       | <b>47%</b>     | <b>38%</b>           |
| <b>Not-Rated/Hold</b>    | <b>105</b>        | <b>4%</b>  | <b>27</b>                        | <b>3%</b>      | <b>26%</b>           |
| <b>Underweight/Sell</b>  | <b>467</b>        | <b>16%</b> | <b>113</b>                       | <b>11%</b>     | <b>24%</b>           |
| <b>Total</b>             | <b>2,853</b>      |            | <b>1022</b>                      |                |                      |

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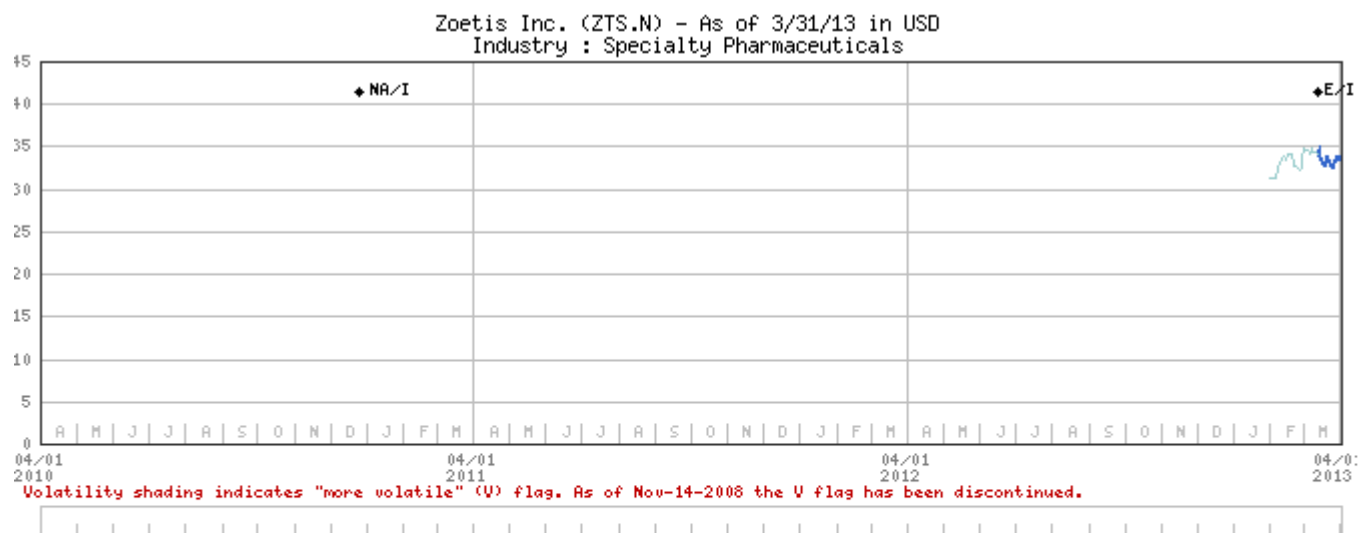
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

## Stock Price, Price Target and Rating History (See Rating Definitions)

April 1, 2013

Zoetis Inc.



Stock Rating History: 12/26/10 : NA/I; 3/13/13 : E/I

Price Target History: 3/13/13 : NA

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)  
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —  
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View  
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)  
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April 1, 2013

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## Industry Coverage: Specialty Pharmaceuticals

| Company (Ticker)                              | Rating (as of) | Price* (03/28/2013) |
|---|----------------|---------------------|
| <b>David Risinger</b>                         |                |                     |
| Actavis Inc (ACT.N)                           | O (01/25/2012) | \$92.11             |
| Alkermes Plc. (ALKS.O)                        | O (01/10/2013) | \$23.7              |
| Allergan Inc. (AGN.N)                         | O (09/07/2010) | \$111.63            |
| Forest Laboratories Inc. (FRX.N)              | E (04/26/2011) | \$38.04             |
| Mylan Inc. (MYL.O)                            | E (03/01/2013) | \$28.95             |
| Perrigo Co. (PRGO.O)                          | O (02/04/2013) | \$118.74            |
| Teva Pharmaceutical Industries Ltd. (TEVA.N)  | E (02/06/2012) | \$39.68             |
| Valeant Pharmaceuticals International (VRX.N) | E (09/14/2012) | \$75.02             |
| Warner Chilcott Plc (WCRX.O)                  | U (08/21/2012) | \$13.55             |
| Zoetis Inc. (ZTS.N)                           | E (03/13/2013) | \$33.4              |
| <b>Marshall Urist, M.D., Ph.D.</b>            |                |                     |
| Hospira (HSP.N)                               | E (07/16/2009) | \$32.83             |
| Sagent Pharmaceuticals Inc (SGNT.O)           | E (08/13/2012) | \$17.55             |

Stock Ratings are subject to change. Please see latest research for each company.  
\* Historical prices are not split adjusted.