



Rating
Buy

North America
United States

Health Care
Pharmaceuticals /
Specialty

Company
Zoetis Alert

Reuters
ZTS.N

Bloomberg
ZTS US

Exchange
NYS
Ticker
ZTS

Date
7 July 2013

Company Update

Price at 5 Jul 2013 (USD)	30.17
Price target	38.00
52-week range	34.64 - 29.28

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Recent Share Price Weakness Offers Attractive Entry Point

After posting a strong performance following its February 6 initial public offering, Zoetis shares have declined a significant 12% since May 28 (vs -2% for S&P 500). And even after the “overhang” from Pfizer’s distribution of its remaining 80% ownership has recently disappeared, ZTS shares have barely rebounded. In our view, ZTS shares should trade at a significant premium to its forward growth rate, given its unique characteristics (see below). Hence, trading at 18.6x consensus 2014 EPS est (vs 21.0x previously), the shares currently appear attractive not only for the long-term but now on a relatively near-medium term basis as well. In our initiation report (March 12), we had argued that as there are no true comparables, IDEXX Labs in veterinary diagnostics (dominant player in its “niche”), Perrigo in Specialty Pharma (very large consumer component, minimal exposure to generics; we had also used Allergan previously), and consumer companies (i.e., P&G, Unilever, Reckitt) offered perhaps the best valuation proxies. While IDEXX’s, Perrigo’s, and the three aforementioned consumer companies maintain forward PEG ratios (taking into consideration variances in growth rates) of 1.7x, 1.5x, and in excess of 2.3x, ZTS’ has declined from 1.6x to 1.4x. Previously, ZTS’s PEG ratio was in line with IDEXX’s and higher than Perrigo’s.

Animal Health is a Good Business; ZTS Remains Positioned to Benefit From Two Long Term Secular Trends

As discussed in our initiation report, strong brand loyalty amongst key customers (livestock producers, veterinarians), being a largely “cash pay” business outside the scope of 3rd party payors, having minimal impact from generic drug entrants, and benefitting from low risk R&D, are just some of the characteristics of why animal health is a very good business. Customers are also generally “price inelastic”. Moreover, worldwide demand for animal protein products is expected to double in the next 40 years. And given natural resource constraints, higher efficiency livestock production will be critical. Further, ownership and spending per companion animal continues to grow globally. In both cases, there should be a sustained, increased need for medications to 1) maintain livestock health and 2) treat chronic conditions in pets.

While Focus Should Be on Annual Performance, Investor Concerns Regarding Q2 Likely Reason for Weakness

While these issues were discussed on the Q1 call (April 30), we believe at least a significant portion of the recent share weakness relate to concerns over 1) Q2 being the last difficult drought comparable, 2) timing of price increases (taken 1Q13 vs Q2 last year), 3) a sluggish start to the parasiticide season in Europe due to cold weather, and 4) ZTS had taken advantage of Novartis being out of the market in 2012/1Q13 for a product. In addition, a large competitor had recently indicated a cold, rainy Spring in Europe had impacted its paraciticide business. As such, animal health businesses tend to be less consistent on a quarterly basis and is the key reason why ZTS only offers annual guidance. As it is virtually impossible to track the business (e.g., no IMS Rx or analogous data available as ZTS sells directly to its customers), quarterly results will be similarly difficult to predict. Ironically, it’s arguably a more predictable business long term vs human based pharma. And at this valuation, our sense is that a soft quarter – if there is one – is likely priced in.

Stock & option liquidity data

Market cap (USD)	15,098.6
Shares outstanding (m)	500.4
Free float (%)	100
Volume (5 Jul 2013)	2,932,656
Option volume (und. shrs., 1M avg.)	–

Key data

FYE 12/31	2012A	2013E	2014E
1Q EPS	–	0.36A	–
2Q EPS	–	0.35	–
3Q EPS	–	0.33	–
4Q EPS	–	0.37	–
FY EPS (USD)	1.08	1.41	1.60
P/E (x)	–	21.4	18.9

* Includes the impact of FAS123R requiring the expensing of stock options.

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