

Zoetis Inc.

ZTS - BUY - Animal Health Industry Read-Throughs from Novartis
Animal Health and Elanco 4Q13 Earnings

LOUISE CHEN, ANALYST

louise.chen@guggenheimpartners.com
212 381 4195

SWATI KUMAR, ASSOCIATE

swati.kumar@guggenheimpartners.com
212 918 8754

FLASH NOTE

SECTOR: Specialty Pharmaceuticals

January 30, 2014

Takeaways from 4Q13 earnings for Elanco and Novartis indicate: 1) good prospects for positive margin growth in the production animal business going into 2014, as we see continued signs of the industry exiting the down cycle due to both volume growth and higher prices; 2) overall growth in the companion animal industry, particularly in Europe and the U.S.; and 3) M&A focus on emerging markets, which remains a strong growth driver in the overall animal health market.

Elanco (LLY)

- **Elanco expects to continue to outperform/exceed the overall industry growth in 2014.** Elanco delivered 4Q13 revenue growth of 6% in performance terms (excluding F/X impact). Growth this quarter was driven by higher prices for both production and companion animal products as well as volume growth for production animal products. This was partially offset by a volume decline for companion animal products. In the U.S., animal health sales decreased 2% due to lower volume and was partially offset by price increases. Animal health sales outside the U.S. increased 16% in performance terms due to increased volume for the most part. Benefit due to higher prices was incremental. For the full year, total animal health sales grew 7% in performance terms mainly due to the growth of companion animal products as well as incremental benefits from higher prices. Animal health sales for full year 2013 in the U.S. increased 6% mainly due to higher volumes of Trifexis. Animal health sales outside the U.S. increased 8% as a result of higher volume as well.
- **Elanco's M&A focus on emerging markets and vaccines.** During the conference call, when asked about M&A prospects in Animal Health, CEO John Lechleiter said, "With respect to Elanco, I think we have said that we intend to be buyers and not sellers in the animal health space. We have done more or less one or two acquisitions, smaller acquisitions, every year for the past five or six years. We have grown this business nicely over this period through a combination of inorganic moves and organic growth. We are going to continue to be interested in M&A and the animal health area that helps us increase our coverage in the area of vaccine and also provide us with a greater presence in some of the key emerging markets."

Novartis (NVS)

- **Novartis Animal Health earnings results highlighted strong companion animal products growth in Europe & U.S.** During 4Q13, Novartis Animal Health delivered double-digit constant currency growth. In the U.S., growth was driven by continued market share gain of key products since the company resumed shipments in North America from the Lincoln manufacturing site. Sentinel (companion animal parasiticide), which was re-launched in the U.S. in 2Q13, showed meaningful growth. In Europe, Animal Health sales posted double-digit constant currency growth driven by the performance of Milbemax (#1 de-wormer for cat & dogs in Europe). Key companion animal therapeutics Atopica (atopic dermatitis) and Onsior (a non-steroidal anti-inflammatory drug) delivered strong growth in 4Q13. For the full year, Novartis Animal Health delivered high single-digit constant currency growth. Beyond Europe and North America, Denagard (anti-infective for pigs and poultry) continued to drive growth in Southeast Asia. Emerging growth markets delivered high single-digit constant currency growth, led by Russia, India, and Vietnam.
- **Asset swap of Novartis Animal Health remains a potential and feasible option.** During the conference call, when asked about the overlap in the back office between the Animal Health & OTC divisions and the realizations of potential synergies if a swap was to occur, CEO Joe Jimenez said, "In terms of the asset swaps, there's very little overlap between the back offices of Animal Health and OTC. So these are quite standalone businesses. While there was some sharing of services, they are quite separate. So I don't think logistically that is going to be an issue."

Potential Catalysts. 1) Operating margin expansion; 2) new product launches; 3) business development; 4) expansion into adjacent categories; 5) U.S. drought subsidies.

Prices of companies mentioned: Eli Lilly (LLY, NC, \$53.91), Novartis (NVS, NC, \$79.27); Zoetis (ZTS, BUY, \$30.78)

ANALYST CERTIFICATION

By issuing this research report, each Guggenheim Securities, LLC ("Guggenheim Securities") research analyst whose name appears in this report hereby certifies that (i) all of the views expressed in this report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers discussed herein and (ii) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst.

IMPORTANT DISCLOSURES

The research analyst(s) and research associate(s) have received compensation based upon various factors, including quality of research, investor client feedback, and Guggenheim Securities, LLC's overall revenues, which includes investment banking revenues.

Guggenheim Securities, LLC managed or co-managed a public offering of securities for Zoetis Inc. during the past 12 months.

Zoetis Inc. is or was during the 12-month period preceding the date of the distribution of this report a client of Guggenheim Securities, LLC. Guggenheim Securities, LLC provided Zoetis Inc. investment banking services.

Guggenheim Securities, LLC or its affiliates received compensation for investment banking services from Zoetis Inc. during the past 12 months.

Guggenheim Securities, LLC or its affiliates expect(s) to receive or intend(s) to seek compensation for investment banking services from Zoetis Inc. in the next 3 months.

Please refer to this website for company-specific disclosures referenced in this report: <https://guggenheimsecurities.bluematrix.com/sellside/Disclosures.action>. Disclosure information is also available from Compliance, 330 Madison Avenue, New York, NY 10017.



RATING DEFINITIONS

BUY (B) - Describes stocks that we expect to provide a total return (price appreciation plus yield) of 15% or more within a 12-month period.

NEUTRAL (N) - Describes stocks that we expect to provide a total return (price appreciation plus yield) of plus 15% or minus 15% within a 12-month period.

SELL (S) - Describes stocks that we expect to provide a total negative return (price appreciation plus yield) of 15% or more within a 12-month period.

NR - The investment rating and price target have been temporarily suspended. Such suspensions are in compliance with applicable regulations and/or Guggenheim Securities, LLC policies.

CS - Coverage Suspended. Guggenheim Securities, LLC has suspended coverage of this company.

NC - Not covered. Guggenheim Securities, LLC does not cover this company.

Restricted - Describes issuers where, in conjunction with Guggenheim Securities, LLC engagement in certain transactions, company policy or applicable securities regulations prohibit certain types of communications, including investment recommendations.

Monitor - Describes stocks whose company fundamentals and financials are being monitored, and for which no financial projections or opinions on the investment merits of the company are provided.

Guggenheim Securities, LLC methodology for assigning ratings may include the following: market capitalization, maturity, growth/value, volatility and expected total return over the next 12 months. The price targets are based on several methodologies, which may include, but are not restricted to, analyses of market 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.

RATINGS DISTRIBUTIONS FOR GUGGENHEIM SECURITIES:

Rating Category	Count	Percent	IB Serv./ Past 12Mos.	
			Count	Percent
Buy	103	48.82%	25	24.27%
Neutral	104	49.29%	12	11.54%
Sell	4	1.90%	0	0.00%

OTHER DISCLOSURES

This research is for our clients and prospective clients only. Other than disclosures relating to Guggenheim Securities and its affiliates, this research is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than certain industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the research analyst's judgment. Guggenheim Securities conducts a full-service, integrated investment banking and brokerage business, and one or more of its affiliates conduct an investment management business. Guggenheim Securities is a member of SIPC (<http://www.sipc.org>). Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and our employees trading for our own account that reflect opinions that are contrary to the opinions expressed in this research. Guggenheim Securities or certain of its affiliates conducts an investment management business, trades for its own account, and conducts an investment business, and may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

We and our affiliates, officers, directors, and employees, excluding equity and credit analysts, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives, if any, referred to in this research. We and our affiliates also may sell to or buy from customers on a principal basis the securities described herein. We and our affiliates also do business with, or that relates to, companies covered in Guggenheim Securities' research, and may have a position in the debt of the company or companies discussed herein.

This research is not an offer to sell or the solicitation of an offer to buy any security. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments.

TACTICAL TRADING IDEA DISCLAIMER

Guggenheim Securities, LLC produces "Tactical Trade Ideas" that identify short-term, catalyst-driven trading opportunities impacting companies within the Firm's coverage universe. Tactical Trade Ideas may exist on companies in this report and may be contrary to the analyst's published rating.

Copyright © 2014 by Guggenheim Securities, LLC, ("Guggenheim") a FINRA registered broker-dealer. All rights reserved. The contents of this report are based upon information or are obtained from sources that Guggenheim generally considers reliable, but Guggenheim makes no representations or warranties with respect to their accuracy, completeness, timeliness, suitability or otherwise, and assumes no responsibility to update them for subsequent events or knowledge. Guggenheim is not responsible for your use of this information.

Contact Information

NEW YORK SALES & TRADING DESK

212 292 4700

EQUITY TRADING DESK

212 292 4701

MEDIA INQUIRIES

310 367 6567

EMAIL

general@guggenheimcm.com

Locations

NEW YORK330 Madison Avenue
New York, NY 10017**WASHINGTON, DC**1055 Thomas Jefferson Street, NW
Suite 450
Washington, DC 20007**BOSTON**500 Boylston Street, 13th Floor
Boston, MA 02116**LOS ANGELES**601 South Figueroa Street
Suite 4005
Los Angeles, CA 90017**DALLAS**1717 McKinney Avenue
Suite 870
Dallas, TX 75202**SAN FRANCISCO**50 California Street
San Francisco, CA 94111**NASHVILLE**104 Woodmont Blvd
Suite 203
Nashville, TN 37205**HERNANDO**1288 Byhalia Road
Suite 2
Hernando, MS 38632**RICHMOND**919 East Main Street
Suite 1605
Richmond, VA 23219

Guggenheim Equity Research

AUTOMOTIVE**Matthew Stover, Analyst**matthew.stover@guggenheimpartners.com
617 859 4605**Brendon Mason, Associate**brendon.mason@guggenheimpartners.com
617 859 4624**ENERGY: EXPLORATION & PRODUCTION****Rob Cordray, Analyst**robert.cordray@guggenheimpartners.com
972 638 5509**Steven Hader, Associate**steven.hader@guggenheimpartners.com
972 638 5507**ENERGY: OIL SERVICES & EQUIPMENT****Darren Gacia, Analyst**darren.gacia@guggenheimpartners.com
212 293 3054**Michael Gunther, Associate**michael.gunther@guggenheimpartners.com
212 518 9782**Michael LaMotte, Analyst**michael.lamotte@guggenheimpartners.com
972 638 5502**Wilson Waggoner, Associate**wilson.waggoner@guggenheimpartners.com
972 638 5506**FINANCIAL SERVICES:****LARGE-CAP BANKS****Marty Mosby, Analyst**marty.mosby@guggenheimpartners.com
662 469 9595**Mason Mosby, Associate**mason.mosby@guggenheimpartners.com
662 469 9194**FINANCIAL SERVICES: BUSINESS
DEVELOPMENT COMPANIES****Rahul Agarwal, Analyst**rahul.agarwal@guggenheimpartners.com
615 208 1221**FINANCIAL SERVICES: REGIONAL &
COMMUNITY BANKS, CARD NETWORKS****Taylor Brodarick, Analyst**taylor.brodarick@guggenheimpartners.com
615 208 1222**David Darst, Analyst**david.darst@guggenheimpartners.com
615 208 1224**FINANCIAL SERVICES: INSURANCE****Bijan Moazami, Analyst**bijan.moazami@guggenheimpartners.com
202 747 9466**HEALTHCARE: BIOTECH****Bret Holley, Analyst**bret.holley@guggenheimpartners.com
212 293 2820**Daniel Chung, Associate**daniel.chung@guggenheimpartners.com
212 518 9771**HEALTHCARE: PHARMACEUTICALS****Louise Chen, Analyst**louise.chen@guggenheimpartners.com
212 381 4195**Swati Kumar, Associate**swati.kumar@guggenheimpartners.com
212 918 8754**RETAIL & CONSUMER****John Heinbockel, Analyst**john.heinbockel@guggenheimpartners.com
212 381 4135**Steven Forbes, Associate**steven.forbes@guggenheimpartners.com
212 381 4188**TMT: MEDIA & ENTERTAINMENT,
CABLE & SATELLITE TV****Michael Morris, Analyst**michael.morris@guggenheimpartners.com
212 381 4162**Curry Baker, Associate**curry.baker@guggenheimpartners.com
212 518 9904