

## COMPANY NOTE

Target | Estimate Change

USA | Healthcare | Pharmaceuticals

May 2, 2013

# Jefferies

## Zoetis, Inc. (ZTS) Earnings Momentum Story Gets Underway

### Key Takeaway

**Zoetis delivered a solid first quarter as a separately listed company. The quality of the earnings beat was decent, with revenues beating by 1% and EPS coming in 9% ahead helped by further operational and financial leverage. We continue to expect a string of earnings beats versus the current consensus and have raised our above consensus 2013E revenue and EPS estimates by 1%.**

**Strong start:** Q1'13 revenues and EPS beat by 1% and 9%, respectively, as Zoetis delivered a strong performance relative to its peers. Management introduced their 2013 EPS guidance range of \$1.36-\$1.42 (JEF \$1.43) with consensus of \$1.38 being at the bottom end of this range. After updating our model for recent business trends and FX movements we have increased our revenue and EPS estimates by up to 1% during the forecast period.

**US market robust despite drought:** Strong poultry and swine product sales more than offset the negative impact of the drought on cattle products, resulting in operational growth of 7% in Q1'13. If the US region emerges out of severe drought conditions during H2'13, we expect it will deliver c6% growth for the full year, supported by continued strength in Companion Animal sales.

**Economy and Weather dogs Europe:** Phasing of price increases in Q1'13 compared to Q2 in 2012 helped drive operational growth of c5% in the quarter. However, several factors (tough PY comps, macroeconomics, cold weather) are expected to pressure revenues over the next few quarters. We currently expect c4% operational revenue growth in 2013E for EuAfME.

**CLAR helped by Companion Animals:** Whilst livestock product sales drove growth in Canada and Brazil, Companion Animal products helped in the developing Latin America regions, resulting in CLAR segment operational growth of 4% in Q1'13. CLAR is expected by us to deliver operational growth of 5% in FY'13E.

**One-offs impact APAC:** A drought in South Australia, regulatory issues in India and avian flu in China limited APAC region operational growth to 1.6% in Q1'13. However, the regulatory issues are being addressed and strong growth in swine and Companion Animal products should deliver a rebound in operational growth of 5% for FY'13E.

### Valuation/Risks

**Valuation:** Our \$41 PT (was \$40) 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	4.6	4.8	4.9	5.1	5.2
EV/Rev		4.6x		4.3x		4.0x		3.8x
EBITDA (B)	--	1.1	--	1.3	--	1.5	--	1.6
EV/EBITDA		17.8x		15.1x		13.1x		12.3x
Dividend	--	0.00	--	0.26	0.30	0.31	--	0.33
Div. Yield		0.00%		0.78%		0.93%		0.99%
PE Relative to Local Market	185%	194%	151%	156%	142%	147%	144%	149%
<b>EPS</b>								
FY Dec	--	1.08	1.42	1.43	1.68	1.70	1.83	1.84
FY P/E		30.9x		23.3x		19.6x		18.1x

**BUY**

Price target \$41.00

(from \$40.00)

Price \$33.39

### Financial Summary

Net Debt (MM): \$2,905.0

### Market Data

52 Week Range: \$35.42 - \$26.00

Total Entprs. Value (MM): \$19,600.0

Market Cap. (MM): \$16,695.0

Shares Out. (MM): 500.0

Float (MM): 99.0

Avg. Daily Vol.: 3,123,170

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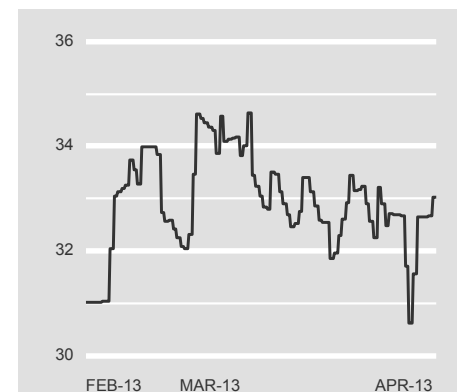
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### Price Performance



## Forecast Changes, Financial Models, and Catalysts

### Exhibit 1: Zoetis Key changes to forecasts, 2012A-2017E

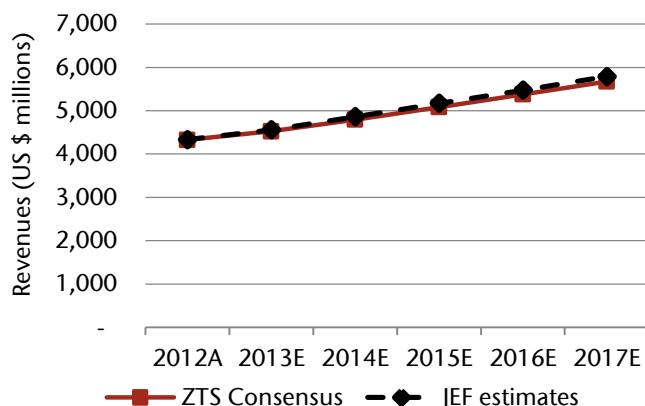
(\$) millions	2012A	2013E	2014E	2015E	2016E	2017E	Incr. abs. '12A-'17E	CAGR '12E-'17E
<b>Net sales</b>								
Prior estimates	4,336	4,510	4,812	5,117	5,417	5,729	1,393	<b>5.7%</b>
New estimates	4,336	4,559	4,863	5,172	5,474	5,790	1,454	<b>6.0%</b>
Change	<b>0%</b>	<b>1%</b>	<b>1%</b>	<b>1%</b>	<b>1%</b>	<b>1%</b>		
<b>Sales growth (%)</b>								
Prior estimates	na	5%	7%	6%	6%	6%		
New estimates	na	5%	7%	6%	6%	6%		
<b>JEF vs. Consensus</b>								
Consensus Sales est.	4,328	4,525	4,798	5,085	5,380	5,673		
JEF vs. Cons. Sales	0%	1%	1%	2%	2%	2%		
<b>Diluted EPS</b>								
Prior estimates	\$1.08	\$1.42	\$1.68	\$1.83	\$2.12	\$2.43	\$1.35	<b>17.6%</b>
New estimates	\$1.08	\$1.43	\$1.70	\$1.84	\$2.13	\$2.44	\$1.36	<b>17.7%</b>
Change	<b>0%</b>	<b>1%</b>	<b>1%</b>	<b>1%</b>	<b>1%</b>	<b>0%</b>		
<b>EPS growth (%)</b>								
Prior estimates	na	31%	19%	9%	16%	15%		
New estimates	na	33%	19%	8%	15%	14%		
<b>JEF vs. Consensus</b>								
Consensus EPS est.	1.15	\$1.39	\$1.61	\$1.81	\$2.02	\$2.31	\$1.16	<b>15.0%</b>
JEF vs. Cons. EPS	-6%	3%	5%	2%	6%	6%		

Source: Jefferies estimates, company data

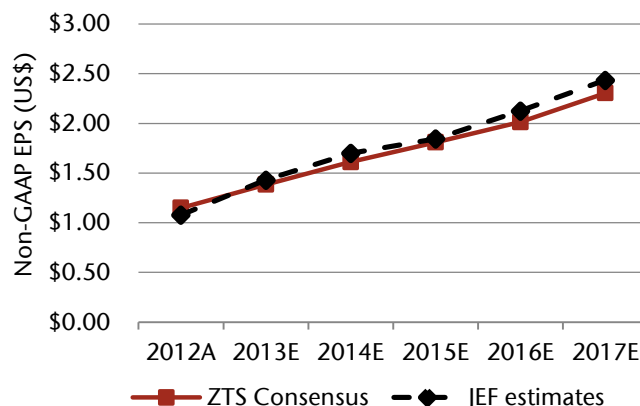
### Exhibit 2: Jefferies 2013 estimates versus management guidance

Metric	Guidance/Goal	JEF Estimate
Revenues	\$4.425 - \$4.525bn	\$4.559bn
Cost of sales	35.0% - 36.0%	35.5%
SG&A	\$1.385 - \$1.435bn	\$1.415bn
R&D	\$385 - \$415m	\$393m
Interest expense	C\$115m	\$114m
Other (income)/deductions	(c20m)	(\$22m)
Tax rate	Approx. 29.5%	29.4%
Non-GAAP EPS	\$1.36 - \$1.42	\$1.43

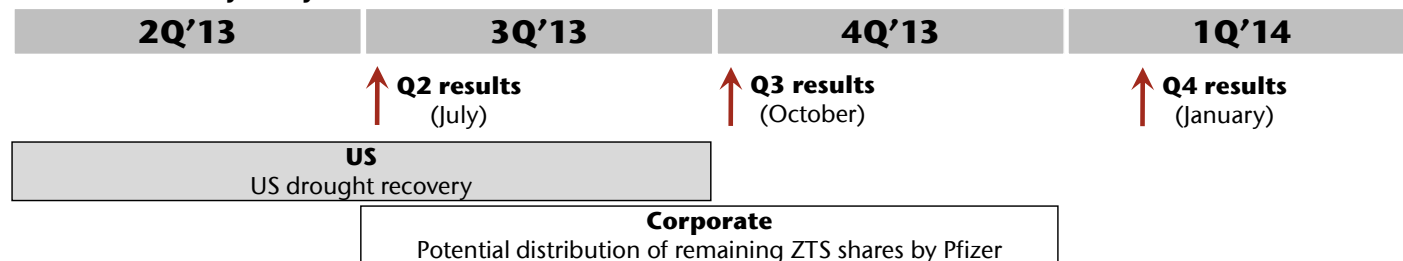
Source: Jefferies estimates, company data

**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
<b>Total Sales</b>	<b>4,336</b>	<b>4,559</b>	<b>4,863</b>	<b>5,172</b>	<b>5,474</b>	<b>5,790</b>	<b>1,454</b>	<b>6.0%</b>
<b>U.S.</b>	<b>1,776</b>	<b>1,877</b>	<b>1,987</b>	<b>2,097</b>	<b>2,202</b>	<b>2,312</b>	<b>536</b>	<b>5.4%</b>
<b>ex-US</b>	<b>2,560</b>	<b>2,682</b>	<b>2,876</b>	<b>3,075</b>	<b>3,272</b>	<b>3,478</b>	<b>918</b>	<b>6.3%</b>
YOY growth (%)	2%	5%	7%	6%	6%	6%		
Underlying growth	6%	5%	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%		
<b>US</b>	<b>1,776</b>	<b>1,877</b>	<b>1,987</b>	<b>2,097</b>	<b>2,202</b>	<b>2,312</b>	<b>536</b>	<b>5.4%</b>
YOY growth (%)	7%	6%	6%	5%	5%	5%		
Underlying growth	7%	6%	6%	5%	5%	5%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	0%	0%	0%	0%	0%	0%		
<b>EuAfME</b>	<b>1,096</b>	<b>1,142</b>	<b>1,202</b>	<b>1,262</b>	<b>1,319</b>	<b>1,378</b>	<b>282</b>	<b>4.7%</b>
YOY growth (%)	-4%	4%	5%	5%	4%	4%		
Underlying growth	3%	3%	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%		
<b>CLAR</b>	<b>769</b>	<b>808</b>	<b>880</b>	<b>959</b>	<b>1,036</b>	<b>1,114</b>	<b>345</b>	<b>7.7%</b>
YOY growth (%)	-2%	5%	9%	9%	8%	8%		
Underlying growth	6%	5%	9%	9%	8%	8%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	-8%	0%	0%	0%	0%	0%		
<b>APAC</b>	<b>695</b>	<b>732</b>	<b>794</b>	<b>854</b>	<b>918</b>	<b>987</b>	<b>292</b>	<b>7.3%</b>
YOY growth (%)	8%	5%	8%	8%	8%	8%		
Underlying growth	8%	5%	9%	8%	8%	8%		
Acquisition	0%	0%	0%	0%	0%	0%		
Divested products	0%	0%	0%	0%	0%	0%		
FX	0%	0%	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
<b>Net sales</b>	<b>4,336</b>	<b>4,559</b>	<b>4,863</b>	<b>5,172</b>	<b>5,474</b>	<b>5,790</b>	<b>1,454</b>	<b>6.0%</b>
COGS	1,549	1,618	1,696	1,841	1,927	2,014	465	5.4%
<b>Gross profit</b>	<b>2,787</b>	<b>2,942</b>	<b>3,168</b>	<b>3,330</b>	<b>3,547</b>	<b>3,776</b>	<b>989</b>	<b>6.3%</b>
SG&A	1,450	1,415	1,443	1,501	1,531	1,561	111	1.5%
R&D	399	393	405	421	429	438	39	1.9%
Amortization (Intangible Assets)	15	15	16	15	17	15	(0)	-0.4%
Other (income)/Expenses	(19)	(22)	(32)	(32)	(32)	(32)	(13)	11.0%
<b>Total Operating Expenses</b>	<b>1,845</b>	<b>1,802</b>	<b>1,831</b>	<b>1,905</b>	<b>1,945</b>	<b>1,982</b>	<b>137</b>	<b>1.4%</b>
<b>Operating Profit</b>	<b>942</b>	<b>1,140</b>	<b>1,336</b>	<b>1,426</b>	<b>1,603</b>	<b>1,794</b>	<b>852</b>	<b>13.8%</b>
<b>EBITDA</b>	<b>1,099</b>	<b>1,307</b>	<b>1,506</b>	<b>1,595</b>	<b>1,769</b>	<b>1,955</b>	<b>856</b>	<b>12.2%</b>
Net interest (income)/expense	31	114	119	115	103	89	58	23.6%
<b>Pretax Income</b>	<b>911</b>	<b>1,026</b>	<b>1,217</b>	<b>1,310</b>	<b>1,500</b>	<b>1,704</b>	<b>794</b>	<b>13.4%</b>
Taxes	372	301	355	376	422	472	100	4.9%
Tax rate	40.8%	29.4%	29.2%	28.7%	28.2%	27.7%	(1,313)bps	
<b>NI before non-control. Int.</b>	<b>539</b>	<b>725</b>	<b>862</b>	<b>935</b>	<b>1,077</b>	<b>1,233</b>	<b>694</b>	<b>18.0%</b>
Less: NI attrib to non-control int.	-	3	4	4	4	4	4	
<b>Net income</b>	<b>539</b>	<b>722</b>	<b>858</b>	<b>931</b>	<b>1,073</b>	<b>1,229</b>	<b>690</b>	<b>17.9%</b>
<b>DILUTED EPS</b>	<b>\$1.08</b>	<b>\$1.43</b>	<b>\$1.70</b>	<b>\$1.84</b>	<b>\$2.13</b>	<b>\$2.44</b>	<b>\$1.36</b>	<b>17.7%</b>
Wt. avg. dil. shares outstanding	500	505	505	505	505	505		
<b>Dividend per share</b>	<b>na</b>	<b>0.26</b>	<b>0.31</b>	<b>0.33</b>	<b>0.38</b>	<b>0.44</b>		
<b>Margin Analysis</b>	<b>2012A</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>		
COGS	35.7%	35.5%	34.9%	35.6%	35.2%	34.8%		
Gross margin	64.3%	64.5%	65.1%	64.4%	64.8%	65.2%	94 bps	
SG&A	33.4%	31.0%	29.7%	29.0%	28.0%	27.0%	(647)bps	
R&D	9.2%	8.6%	8.3%	8.1%	7.8%	7.6%	(164)bps	
Total Operating Expenses	42.6%	39.5%	37.7%	36.8%	35.5%	34.2%	(832)bps	
Operating margin	21.7%	25.0%	27.5%	27.6%	29.3%	31.0%	926 bps	
EBITDA margin	25.4%	28.7%	31.0%	30.8%	32.3%	33.8%	842 bps	
Pretax margin	21.0%	22.5%	25.0%	25.3%	27.4%	29.4%	843 bps	
Net margin	12.4%	15.8%	17.6%	18.0%	19.6%	21.2%	879 bps	
Dividend Payout ratio	na	18.2%	18.0%	18.0%	18.0%	18.0%		
<b>YOY % Change</b>	<b>2012A</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>		
Net sales	2%	5%	7%	6%	6%	6%		
COGS	-2%	4%	5%	9%	5%	5%		
Gross profit	5%	6%	8%	5%	7%	6%		
SG&A	0%	-2%	2%	4%	2%	2%		
R&D	-2%	-1%	3%	4%	2%	2%		
Operating income	17%	21%	17%	7%	12%	12%		
EBITDA	na	19%	15%	6%	11%	11%		
Pretax income	18%	13%	19%	8%	14%	14%		
Net income	7%	34%	19%	8%	15%	14%		
<b>Diluted EPS</b>	<b>7%</b>	<b>33%</b>	<b>19%</b>	<b>8%</b>	<b>15%</b>	<b>14%</b>		
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	634	1,177	1,813	2,321	2,955
Cash and cash equivalents	317	634	1,177	1,813	2,321	2,955
Short-term investments	-	-	-	-	-	-
Accounts receivable	900	993	1,066	1,135	1,202	1,271
Inventories	1,345	1,388	1,490	1,618	1,694	1,772
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
<b>Current assets</b>	<b>2,864</b>	<b>3,317</b>	<b>4,035</b>	<b>4,869</b>	<b>5,519</b>	<b>6,300</b>
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
<b>Total Assets</b>	<b>6,262</b>	<b>6,670</b>	<b>7,342</b>	<b>8,082</b>	<b>8,643</b>	<b>9,342</b>
Short-term debt	73	-	-	-	-	-
Payables and accrued expenses	543	545	569	600	625	652
Accounts payable	319	309	326	352	369	385
Income taxes payable	30	42	49	53	62	72
Accrued comp. and rel. items	194	194	194	194	194	194
Other current liabilities	507	507	507	507	507	507
<b>Current liabilities</b>	<b>1,123</b>	<b>1,052</b>	<b>1,076</b>	<b>1,107</b>	<b>1,132</b>	<b>1,159</b>
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
<b>Total Liabilities</b>	<b>2,221</b>	<b>5,181</b>	<b>5,205</b>	<b>5,136</b>	<b>4,761</b>	<b>4,388</b>
Preferred stock (carrying value)	-	-	-	-	-	-
Business unit equity	4,183	-	-	-	-	-
Equity attrib. to non-control. Int.	15	15	15	15	15	15
Common equity	(157)	1,475	2,122	2,931	3,866	4,940
Retained earnings	-	426	1,073	1,882	2,817	3,891
Other comprehensive	(157)	(157)	(157)	(157)	(157)	(157)
<b>Shareholders' Equity</b>	<b>4,041</b>	<b>1,490</b>	<b>2,137</b>	<b>2,946</b>	<b>3,881</b>	<b>4,955</b>
<b>Total Liabilities and Equity</b>	<b>6,262</b>	<b>6,670</b>	<b>7,342</b>	<b>8,082</b>	<b>8,643</b>	<b>9,342</b>
<b>Net Debt</b>	<b>265</b>	<b>2,906</b>	<b>2,363</b>	<b>1,627</b>	<b>719</b>	<b>(315)</b>

Source: Jefferies estimates, company data

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

<b>(\$ millions)</b>	<b>2012A</b>	<b>2013E</b>	<b>2014E</b>	<b>2015E</b>	<b>2016E</b>	<b>2017E</b>
Pro forma net income	539	722	858	931	1,073	1,229
Adj. for excluded gains (charges)	(103)	(215)	(116)	(15)	(17)	(15)
Net income (GAAP)	436	507	742	915	1,057	1,214
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)	(134)	(151)	(166)	(118)	(120)
<b>Net cash from operating activities</b>	<b>454</b>	<b>627</b>	<b>848</b>	<b>1,003</b>	<b>1,189</b>	<b>1,334</b>
Capital expenditures	(123)	(170)	(170)	(120)	(120)	(120)
Other	(12)	-	-	-	-	-
<b>Net cash from investing activities</b>	<b>(135)</b>	<b>(170)</b>	<b>(170)</b>	<b>(120)</b>	<b>(120)</b>	<b>(120)</b>
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)	-	-	-	-
<b>Net cash from financing activities</b>	<b>(78)</b>	<b>(140)</b>	<b>(136)</b>	<b>(246)</b>	<b>(561)</b>	<b>(580)</b>
Effect of exchange rates	(3)	-	-	-	-	-
Net increase in cash	238	317	543	637	508	634
Cash at beginning of period	79	317	634	1,177	1,813	2,321
<b>Cash at end of period</b>	<b>317</b>	<b>634</b>	<b>1,177</b>	<b>1,813</b>	<b>2,321</b>	<b>2,955</b>

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.

## Analyst Certification

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### Conviction List Methodology

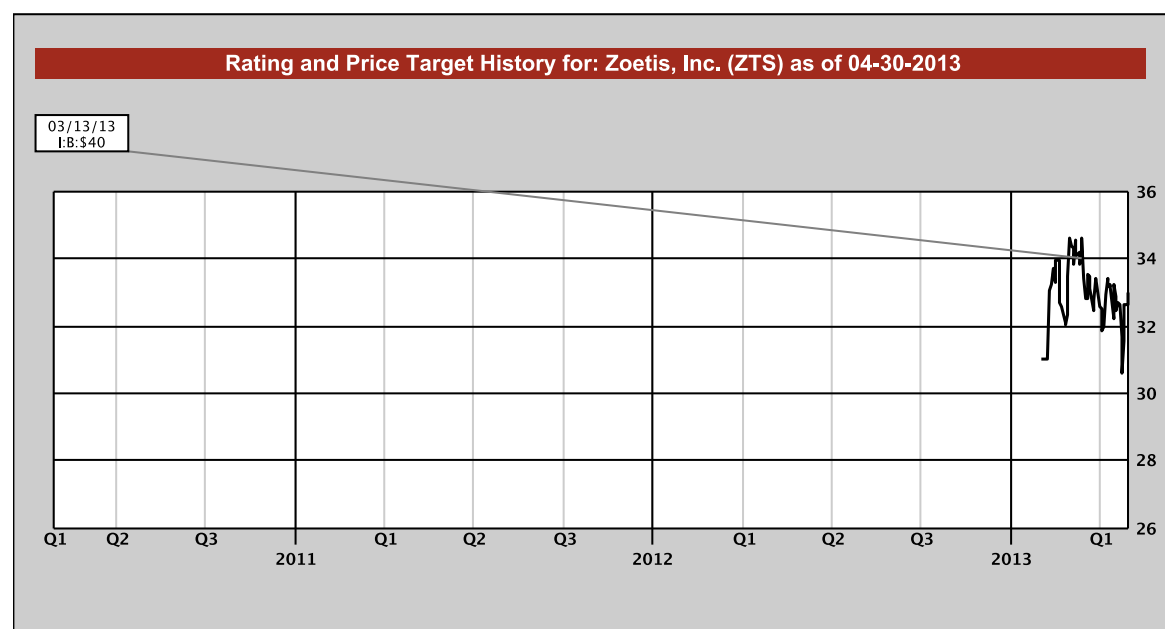
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8. The conviction list is published once a month whilst global equity markets are closed.
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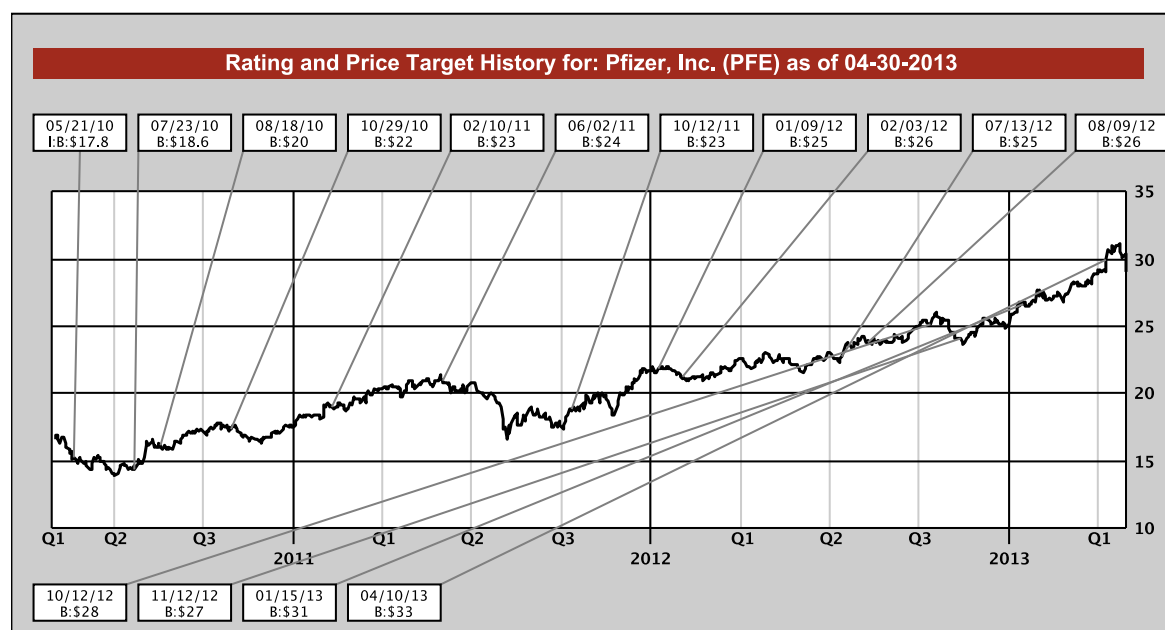
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## Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
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HOLD	737	45.05%	89	12.08%
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