

Zoetis Inc.

## Q1 2013 Earnings Review: Challenges in FY13 but long-term view unchanged

**An in-line top-line, with strength in US/EuAfME companion animals and CLAR livestock, offset by companion animal weakness in CLAR and APAC regions:**

Revenue came in \$11mn above consensus at \$1,090mn (+4% YoY; -1% FX) with US sales up a strong 7% YoY. Companion animals grew +8% YoY, including 10% growth in dogs and cat products, offset slightly by an 8% decline in horse products. Livestock was up a modest 2% with strong growth in Canada and Brazil offset by the negative impact of the drought in the US. Gross margins improved 70bps YoY to 63.5% (versus our estimate of 64%). SG&A was 29.5% of sales (150bps lower than our estimate) and R&D was 8.3% of sales (10bps higher than our estimate). EPS was \$0.36 versus consensus of \$0.33, benefitting from lower SG&A costs.

**Midpoint of revenue guidance suggests +3.2% YoY growth; pressure on top-line due to re-entrance of Sentinel and the EU's delayed parasiticides season:**

Novartis's Animal Health Lincoln site resumed shipments of Sentinel in early April and thus, incremental tailwind for ZTS based on this supply issue will largely be scaled back. Further, challenging macroeconomic conditions in Southern Europe and unseasonably cold weather in Europe (affecting start of parasiticides season) is likely to further challenge growth in the EuAfME in 2013. Regulatory challenges in India also negatively impacted sales although these issues are expected to resolve over the upcoming quarters. FY13 sales and EPS guidance ranges are \$4,425mn to \$4,525mn (consensus of \$4,525) and \$1.36 to \$1.42, respectively (consensus of \$1.38). Guidance assumes a recovery in EU markets and continued US drought impact.

**Business first, then return shareholders:** Priorities for capital allocation include: 1) continued infrastructure build-up; 2) de-levering through debt pay-down; 3) bolt-on acquisitions; and 4) sustain dividend payouts.

ZTS: Quarterly and Annual EPS (USD)

	2012		2013		2014			Change y/y	
FY Dec	Actual	Old	New	Cons	Old	New	Cons	2013	2014
Q1	N/A	0.33E	0.36A	0.33E	0.37E	0.37E	0.38E	N/A	3%
Q2	N/A	0.35E	0.35E	0.36E	0.41E	0.41E	0.42E	N/A	17%
Q3	N/A	0.34E	0.33E	0.35E	0.40E	0.40E	0.39E	N/A	21%
Q4	N/A	0.36E	0.35E	0.33E	0.43E	0.43E	0.40E	N/A	23%
Year	1.08A	1.38E	1.39E	1.38E	1.61E	1.61E	1.60E	29%	16%
P/E	30.2		23.5			20.3			

Source: Barclays Research.

Consensus numbers are from Thomson Reuters

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PLEASE SEE ANALYST(S) CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 6.

Equity Research

Healthcare | U.S. Major Pharmaceuticals

30 April 2013

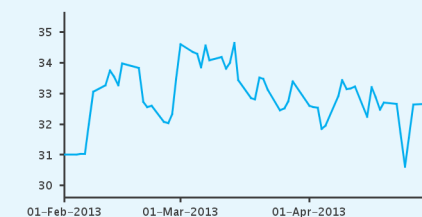
Stock Rating	<b>EQUAL WEIGHT</b>
	Unchanged
Industry View	<b>POSITIVE</b>
	Unchanged
Price Target	<b>USD 35.00</b>
	Unchanged

Price (29-Apr-2013)	USD 32.66
Potential Upside/Downside	+7%
Tickers	ZTS

Market Cap (USD mn)	16330
Shares Outstanding (mn)	500.00
Free Float (%)	99.95
52 Wk Avg Daily Volume (mn)	3.1
Dividend Yield (%)	0.0
Return on Equity TTM (%)	17.20
Current BVPS (USD)	8.05

Source: FactSet Fundamentals

Price Performance	Exchange-NYSE
52 Week range	USD 35.42-30.42



[Link to Barclays Live for interactive charting](#)

U.S. Major Pharmaceuticals

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U.S. Major Pharmaceuticals	Industry View: POSITIVE
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## Zoetis Inc. (ZTS)

Stock Rating: EQUAL WEIGHT

Income statement (\$mn)	2012A	2013E	2014E	2015E	CAGR
Revenue	4,336	4,541	4,806	5,105	5.6%
EBITDA (adj)	1,079	1,262	1,456	1,566	13.2%
EBIT (adj)	942	1,115	1,310	1,452	15.5%
Pre-tax income (adj)	911	1,030	1,200	1,347	13.9%
Net income (adj)	539	723	845	952	20.9%
EPS (adj) (\$)	1.08	1.39	1.61	1.81	18.8%
Diluted shares (mn)	500.0	525.0	525.0	525.0	1.6%
DPS (\$)	N/A	0.26	0.31	0.37	N/A

Price (29-Apr-2013) USD 32.66  
 Price Target USD 35.00

**Why Equal Weight?** Zoetis' current stock price appears fairly valued in our view. Macro headwinds for both the livestock and companion animal sectors will likely limit upside to 2013 earnings. Long-term growth will likely depend on Zoetis' ability to leverage its vast global portfolio to outpace industry growth.

Upside case USD 40.00

Our upside case assumes a strong recovery of the global animal health market in 2013/14 to 5%-6% per year, and Zoetis achieving an EBIT margin expansion to 30% in the longer term. These factors should drive an upside case of \$40.00 or 22x 2015E EPS.

Downside case USD 29.00

Our downside case assumes the stagnation of the global animal health market in 2013/14. Zoetis' growth is on pace with a soft industry outlook, and EBIT margins improves to 27% in the longer term. These factors should lead to a downside of \$29.00 or 16x 2015E EPS.

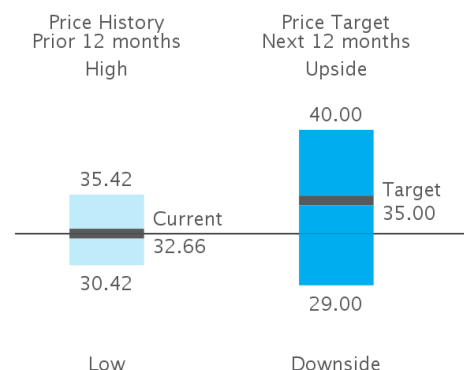
Margin and return data	Average				
EBITDA (adj) margin (%)	24.9	27.8	30.3	30.7	28.4
EBIT (adj) margin (%)	21.7	24.6	27.3	28.4	25.5
Pre-tax (adj) margin (%)	21.0	22.7	25.0	26.4	23.8
Net (adj) margin (%)	12.4	15.9	17.6	18.7	16.1
ROIC (%)	6.2	18.0	16.0	18.3	14.6
ROA (%)	8.6	11.6	11.7	12.3	11.1
ROE (%)	13.3	27.4	42.0	40.5	30.8

Balance sheet and cash flow (\$mn)	CAGR				
Tangible fixed assets	4,409	4,694	5,373	5,879	10.1%
Intangible fixed assets	1,853	1,875	1,856	1,838	-0.3%
Cash and equivalents	317	689	1,180	1,625	72.4%
Total assets	6,262	6,569	7,229	7,717	7.2%
Short and long-term debt	582	3,650	3,650	3,650	84.4%
Other long-term liabilities	589	589	589	589	0.0%
Total liabilities	2,221	5,220	5,220	5,366	34.2%
Net debt/(funds)	265	2,961	2,470	2,025	97.0%
Shareholders' equity	4,041	1,349	2,009	2,350	-16.5%
Change in working capital	273	363	636	-72	N/A
Cash flow from operations	454	677	825	1,169	37.1%
Capital expenditure	-126	-170	-170	-128	N/A
Free cash flow	328	507	655	1,042	47.0%

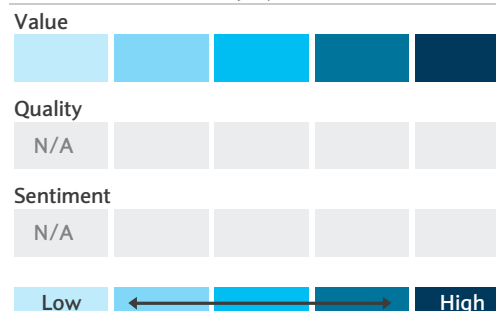
Valuation and leverage metrics	Average				
P/E (adj) (x)	30.2	23.5	20.3	18.0	23.0
EV/EBITDA (adj) (x)	15.4	15.3	12.9	11.7	13.8
P/BV (x)	4.0	12.7	8.5	7.3	8.1
Dividend yield (%)	N/A	0.8	1.0	1.1	1.0
Total debt/capital (%)	12.6	73.0	64.5	60.8	52.7

Selected operating metrics	2012A	2013E	2014E	2015E
SG&A/sales (%)	33.5	30.8	30.0	29.5
R&D/sales (%)	9.2	8.9	8.5	8.3
R&D growth (%)	-2.0	0.8	1.7	3.3
SG&A growth (%)	0.3	-3.6	3.1	4.4

## Upside/Downside scenarios



## POINT® Quantitative Equity Scores

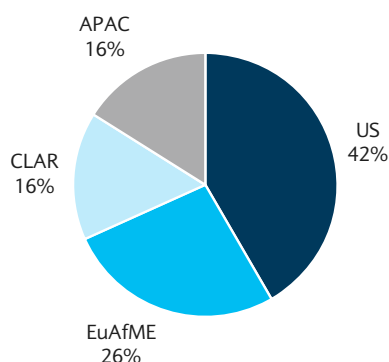


Source: POINT. The scores are valid as of the date of this report and are independent of the fundamental analysts' views. To view the latest scores, click here.

Source: Company data, Barclays Research  
 Note: FY End Dec

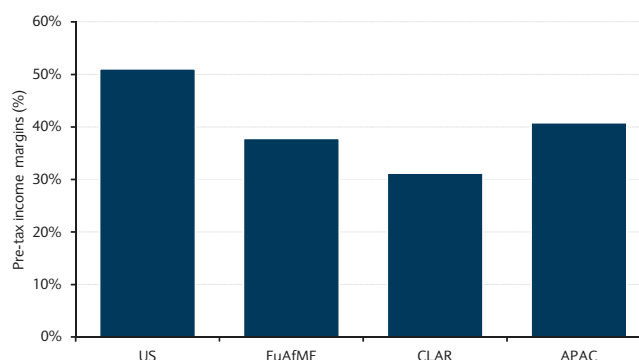
**Strength in EuAfME livestock (swine and poultry) and companion animals, CLAR livestock and US companion animals (Figure 3):** The CLAR region (16% of sales) saw strong operational growth in livestock (+6% YoY, 81% of CLAR sales) driven by Canada cattle and Brazil's swine and poultry sales. Canada's companion animals experienced weakness due to tough comps from a favorable impact of competitor supply in 1Q12. APAC (16% of sales) saw modest operational growth across all species with livestock sales growth of +3% operationally (81% of APAC sales). The US market gained +13% YoY in companion animals (46% of US sales) benefitting from competitor supply issues (likely Novartis). Novartis's Animal Health Lincoln site resumed shipments of Sentinel in early April and thus, incremental tailwind for ZTS based on this supply issue will largely be scaled back in upcoming quarters. US livestock sales (54% of US sales) experienced strong poultry and swine sales although negative impact from the drought continues to weigh down sales.

FIGURE 1  
Sales % breakdown by Region



Source: Barclays Research. Company Reports.

FIGURE 2  
Pre-tax Income margins (%)



Source: Barclays Research. Company Reports.

FIGURE 3  
Performance of Key Regions and Species/Segments

	Mix - % of Total	1Q13
Livestock (+2% rep, +3% op)	Cattle = 55%	
- Cattle (-3% rep, -2% op)	Swine = 22%	
- Swine (+10% rep, +11% op)	Poultry = 19%	
- Poultry (+10% rep, +12% op)	Other = 4%	
- Other (-7% rep, -3% op)		
Companion Animal (+8% rep, -8% op)	Horses = 11%	
- Horses (-7% rep, -8% op)	Dogs and Cats = 89%	
- Dogs and Cats (+10% rep, +10% op)		
CLAR (-1% rep, +4% op)	Livestock = 81%	- <b>Canada</b> had strong cattle sales but companion animals weak due to favorable impact of competitor supply in 1Q12
- Livestock (+1% rep, +6% op)	Companion = 19%	- <b>Brazil</b> had strong swine and poultry sales
- Companion (-9% rep, -5% op)		- <b>LatAm</b> saw growth particularly in Brazil companion animals
APAC (+1% rep, +3% op)	Livestock = 73%	- <b>Australia</b> saw higher sales of swine but drought in <b>southern</b>
- Livestock (+1% rep, +3% op)	Companion = 27%	- <b>Australia</b> negatively impacts dairy industry
- Companion (0% rep, +2% op)		- <b>Japan</b> soft due to continued ongoing economic challenges
EuAfME (+5% rep, +4% op)	Livestock = 67%	- <b>Europe</b> benefit from timing of price increases
- Livestock (+4% rep, +3% op)	Companion = 33%	- Swine and poultry driving livestock growth
- Companion (+8% rep, +6% op)		- <b>S. EU</b> has continued challenges in economic conditions
US (+2%)	Livestock = 54%	- <b>Livestock</b> had strong poultry and swine product sales offset by a decline in product sales for cattle due to drought
- Livestock (+2%)	Companion = 46%	- <b>Companion Animals</b> benefitted from positive impact of competitive supply issue
- Companion (+13%)		

Source: Barclays Research. Company Reports.

**FY13 impacted by multiple challenges but long-term outlook remains unchanged:**

FY2013 guidance (Figure 4) provided on the 1Q13 earnings call included revenue range of \$4,425mn to \$4,525mn, the midpoint of which suggests 3.2% YoY growth. While the growth rate represents an improvement of a low 2.4% YoY increase in FY12, there remain a few factors that may create headwinds for the top-line during 2013. These include:

- The resumption of shipments from Novartis's Lincoln site in early April. Sentinel shipments were restarted in April (in guidance).
- Continued challenges in Southern Europe due to deteriorating macroeconomic conditions (in guidance).
- Delays in regulatory approvals in India expected to impact sales over next few quarters.
- Unseasonably cold weather in Europe, which is likely to delay the start of parasiticides season (typically a 2Q start). Parasiticides comprise nearly 16% of sales (Figure 5) (in guidance).
- Continued impact of the drought in the US. Herd sizes are down an estimated 7-9% and require at least two to three years for recovery. Poultry and swine takes significantly less time to rebuild given the shorter cycles of 45 days and 5-6 months, respectively. Management expects a return to normalcy for poultry and swine by the end of the year (partially in guidance but much uncertainty surrounding impact here).

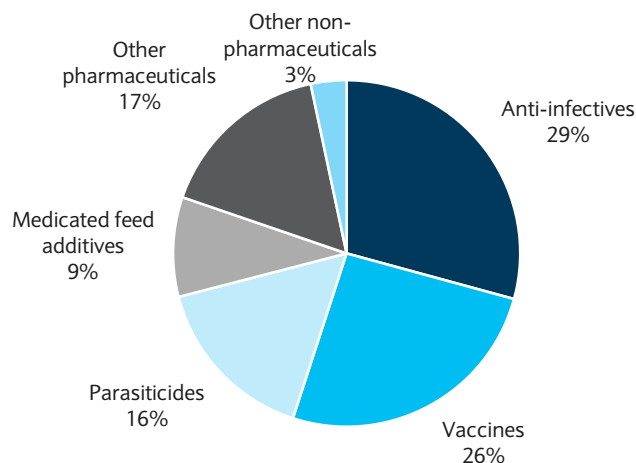
FIGURE 4

**Zoetis FY2013 – Key Guidance Items (in millions \$, except EPS)**

FY13	Guidance	Midpoint	Consensus	Barclays	Barclays vs Midpoint
Revenues	\$4,425 to \$4,525	\$4,475	\$4,525	\$4,541	\$66
COGS (%)	35% to 36%	35.5%	35.4%	35.6%	0.1%
SG&A (%)	\$1,385 to \$1,435	\$1,410	\$1,441	\$1,400	-\$10
R&D (%)	\$385 to \$415	\$400	\$404	\$402	\$2
Tax rate (%)	~29.5%	29.5%	29.4%	29.5%	0.0%
EPS - Non-GAAP	\$1.36 to \$1.42	\$1.39	\$1.38	\$1.39	\$0.00

Source: Barclays Research. Company Reports.

FIGURE 5

**FY12 sales by product category**

Source: Barclays Research. Company Reports.

**Long-term macro trends for the animal health industry appear positive (consulting firm Vetnosis estimates a 5.7% CAGR from 2011A to 2015E):** An emerging middle class, an expanding population size and constraints on protein supply are all expected to contribute to strong growth within the Animal Health market. Zoetis is a market leader across multiple geographies and is highly diversified across geographies, species and product categories. Whether or not Zoetis can outpace industry growth remains to be seen, and we expect management to continue to supplement its mature portfolio with inorganic opportunities to boost growth. Management also reiterated a commitment to shareholder returns in the long run.

**Model Update:** We are raising our FY13 EPS from \$1.38 to \$1.39 based on softer SG&A spending and better gross margins. Our 2Q13 revenue of \$1,135mn is largely in-line with consensus estimate of \$1,140mn. For the FY2013, our revenue estimate of \$4,541mn is ~\$16mn above consensus and \$66mn above the midpoint of guidance range (\$4,425mn to \$4,525mn). We forecast gross margin of 64% and 64.4% for the 2Q13 and FY13, respectively. We anticipate R&D spend would reach 8.9% of sales for FY13 and SG&A of 30.8% of sales for FY13. Our total FY13 SG&A and R&D costs decline 3% YoY, while revenues are expected to increase 5% YoY.

FIGURE 6

## ZTS Model Summary (in millions \$, except EPS)

		13Q1A	13Q2E	13Q3E	13Q4E				CAGR
\$USD M	FY12A	Mar	Jun	Sep	Dec	FY13E	FY14E	FY15E	13-15
>>>TOTAL REVENUE	4,336	1,090	1,135	1,070	1,246	4,541	4,806	5,105	6%
Cost of Goods Sold	1,549	398	409	375	436	1,617	1,663	1,736	
Gross Profit	2,787	692	727	696	810	2,924	3,143	3,370	
SG&A	1,452	322	346	326	405	1,400	1,443	1,507	
R&D	399	90	98	96	118	402	409	423	
Adjusted Operating Income (EBIT)	942	252	290	280	294	1,115	1,310	1,452	
EBITDA	1,079	289	326	317	330	1,262	1,456	1,566	11%
Total Other Income (Expense)	31	0	28	28	28	113	110	105	
Pre-Tax Income	911	252	261	252	265	1,030	1,200	1,347	
Income Taxes	372	73	78	75	79	304	352	391	
GAAP Net Income	436	140	166	159	168	633	777	884	
Adjusted Net Income	539	179	183	176	185	723	845	952	15%
Diluted Shares Outstanding		500	525	525	525	525	525	525	
GAAP Diluted EPS	\$ 0.87	\$ 0.28	\$ 0.32	\$ 0.30	\$ 0.32	\$ 1.22	\$ 1.48	\$ 1.68	
>>>ADJUSTED DILUTED EPS	\$ 1.08	\$ 0.36	\$ 0.35	\$ 0.33	\$ 0.35	\$ 1.39	\$ 1.61	\$ 1.81	14%
Dividend	\$ -	\$ 0.07	\$ 0.07	\$ 0.07	\$ 0.07	\$ 0.26	\$ 0.31	\$ 0.37	20%
Gross Margin	64.3%	63.5%	64.0%	65.0%	65.0%	64.4%	65.4%	66.0%	+ 80 bp
SG&A	33.5%	29.5%	30.5%	30.5%	32.5%	30.8%	30.0%	29.5%	- 65 bp
R&D	9.2%	8.3%	8.6%	9.0%	9.5%	8.9%	8.5%	8.3%	- 30 bp
Operating Margin	21.7%	23.1%	25.5%	26.2%	23.6%	24.6%	27.3%	28.4%	+ 195 bp
EBITDA Margin	24.9%	26.5%	28.7%	29.6%	26.5%	27.8%	30.3%	30.7%	+ 145 bp
Tax Rate	40.8%	6.7%	6.8%	7.0%	6.3%	29.5%	29.3%	29.0%	- 25 bp
Profit Margin	12.4%	16.4%	16.1%	16.4%	14.9%	15.9%	17.6%	18.7%	+ 135 bp
Revenue Growth Y/Y	2%	4%	4%	5%	6%	5%	6%	6%	
Operating Margin Change Y/Y	+ 270 bp	+ 50 bp	+ 30 bp	+ 190 bp	+ 810 bp	+ 280 bp	+ 270 bp	+ 120 bp	
EBITDA Growth Y/Y	15%	11%	4%	8%	56%	17%	15%	8%	
Adjusted Diluted EPS Growth Y/Y						29%	16%	12%	

Source: Barclays Research. Company Reports.

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Zoetis Inc. (ZTS, 29-Apr-2013, USD 32.66), Equal Weight/Positive, A/C/D/F/J/K/L/M/O

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In addition to the stock rating, we provide industry views which rate the outlook for the industry coverage universe as Positive, Neutral or Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

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**Overweight** - The stock is expected to outperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

**Equal Weight** - The stock is expected to perform in line with the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

**Underweight** - The stock is expected to underperform the unweighted expected total return of the industry coverage universe over a 12-month investment horizon.

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**Positive** - industry coverage universe fundamentals/valuations are improving.

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Below is the list of companies that constitute the "industry coverage universe":

### U.S. Major Pharmaceuticals

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Bristol-Myers Squibb (BMY)	Gilead Sciences (GILD)	Johnson & Johnson (JNJ)
Lilly, Eli (LLY)	Merck & Co. (MRK)	Pfizer Inc. (PFE)
Zoetis Inc. (ZTS)		

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Each analyst has a single price target on the stocks that they cover. The price target represents that analyst's expectation of where the stock will trade in the next 12 months. Upside/downside scenarios, where provided, represent potential upside/potential downside to each analyst's price target over the same 12-month period.

### Guide to the POINT® Quantitative Equity Scores:

The POINT Quantitative Equity Scores (POINT Scores) are based on consensus historical data and are independent of the Barclays fundamental analysts' views. Each score is composed of a number of standard industry metrics.

A high/low Value score indicates attractive/unattractive valuation. Measures of value include P/E, EV/EBITDA and Free Cash Flow.

A high/low Quality score indicates financial statement strength/weakness. Measures of quality include ROIC and corporate default probability.

## IMPORTANT DISCLOSURES CONTINUED

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## IMPORTANT DISCLOSURES CONTINUED

## Zoetis Inc. (ZTS)

USD 32.66 (29-Apr-2013)

Stock Rating

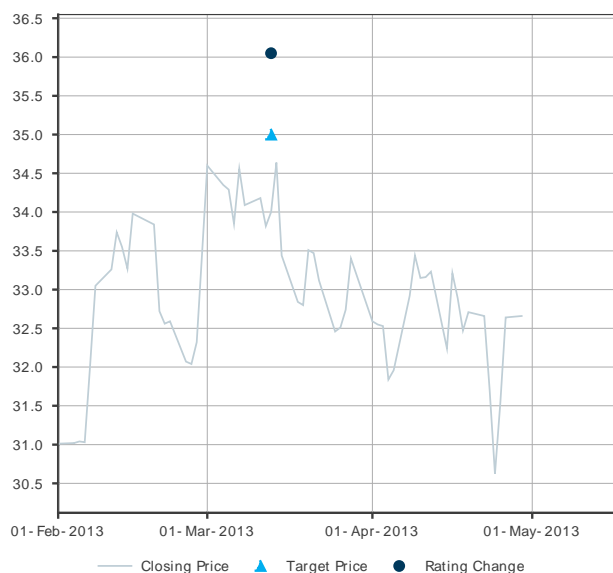
Industry View

EQUAL WEIGHT

POSITIVE

## Rating and Price Target Chart - USD (as of 29-Apr-2013)

Currency=USD



Date	Closing Price	Rating	Price Target
13-Mar-2013	34.00	Equal Weight	35.00

[Link to Barclays Live for interactive charting](#)

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**Valuation Methodology:** Our price target of \$35 is based on a DCF analysis using a 7% discount rate and a 2.5% terminal growth rate. Our price target is 25x our FY2013E EPS of \$1.39 and 19x our FY2015E EPS of \$1.81.

**Risks which May Impede the Achievement of the Barclays Research Price Target:** Risk factors that can materially affect Zoetis' operations and performance include global economic conditions that may affect the consumer's demand for animal proteins and spending on companion animals, potential increase in regulatory scrutiny over the use of antimicrobials in food-producing animals, regulatory and/or funding pressures on livestock production in major markets, changes in consumer demand for animal proteins products due to perceptions of health risks, competition from generic animal health products, outbreak of infectious diseases in animals, and consolidation of customers, particularly in food-producing animal producers, and effects on Zoetis' pricing leverage. Other risks include challenges in integrating recent acquired businesses, setbacks in the R&D pipelines such as failure of clinical trials and denial of drug approvals, manufacturing and capacity shortfalls, as well as challenges to Zoetis' portfolio's patent exclusivity in major markets.

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