

Zoetis Inc. (ZTS)

Overweight

Dairy Expo And Cattle Ranch Checks Give Us Confidence Into Q3 Earnings

CONCLUSION

Heading into Q3 earnings, we remain confident that ZTS will meet or slightly exceed expectations. While the livestock market has presented some challenges over the last 12+ months due to the drought in 2012, we believe the cattle market is improving and results should be good over the next couple of quarters. Our recent channel checks give us confidence that the market is improving and this will ultimately benefit ZTS. Recently, we conducted a survey at the World Dairy Expo and visited a cattle ranch in western Kentucky, including a trip to the local stockyard for a cattle auction. These checks were positive for ZTS and we maintain our Overweight rating and \$39 PT.

- **Fall calf run just starting.** Due to the good moisture this summer, cattle have been out to pasture through the end of September and the fall calf run is starting later than initially expected. Additionally, feed costs are low, which is expected to drive higher prices for the fall calf run. Other than the minor set back due to the early snowstorm in western South Dakota and parts of Nebraska and Wyoming, we believe the cattle market is good and showing early signs of recovery. With lower feed prices and a good corn crop, we expect cattle on feed reports to improve over the remaining months of the year, once the USDA's website is operating when the government shutdown ends. Ultimately, we believe the environment is improving and benefits ZTS.
- **Cattle ranch and stockyard visit highlights.** We recently visited a cattle ranch (cow-calf operation) in western Kentucky and came away feeling good about cattle market in that part of the country. There was plenty of hay and grass due to the good moisture this year and the corn harvest was just about to begin. We noticed several calves being weaned from mothers and deworming medication (Merial) was being applied for the fall. During our visit we also went to the local stockyard and watched two auctions for calves, heifers, and bulls. Prices were slightly lower than what our host was expecting, but we believe prices were still pretty good for the Angus bulls and calves.
- **Expect solid Q3 results.** ZTS reports Q3 earnings before the open on Tuesday, November 5th. CC at 8:30 AM ET, dial-in #: 866-952-1906, conference ID: ZTSQ313. Heading into the print, we think Q3 results will be in-line to slightly better than Street expectations as ZTS felt the greatest impact from the drought during 3Q12 making for an easier comp. Additionally, our diligence throughout the quarter indicated ZTS ran customer loyalty promotions in July and August, which could help bolster sales ahead of the fall calf run. Important topics this quarter will include an update on product development activity and color on market conditions, including the impact of the early snowstorms.

RISKS TO ACHIEVEMENT OF PRICE TARGET

Risks include increased regulatory pressures, adverse weather conditions, lower utilization of products, increased competition, and macro economic factors.

COMPANY DESCRIPTION

Zoetis is the leading global manufacturer of animal health medications and vaccines.

PRICE: US\$31.43
TARGET: US\$39.00
(24.5x FY14E EPS)

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$39.00
FY13E Rev (mil)	—	US\$4,495.8
FY14E Rev (mil)	—	US\$4,733.0
FY13E EPS	—	US\$1.40
FY14E EPS	—	US\$1.59
52-Week High / Low	US\$35.42 / US\$26.00	
Shares Out (mil)	500.2	
Market Cap. (mil)	US\$15,721.3	
Avg Daily Vol (ooo)	4,916	
Book Value/Share	US\$1.45	
Net Cash Per Share	US\$0.00	
Debt to Total Capital	83%	
Div (ann)	US\$0.26	
Yield	0.83%	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2012A	1,047.0	1,094.0	1,019.0	1,176.0	4,336.0	3.6x	0.30	0.35	0.31	0.11	1.08	29.1x
2013E	1,090.0A	1,114.0A	1,070.4	1,221.4	4,495.8	3.5x	0.36A	0.36A	0.34	0.34	1.40	22.5x
2014E	1,142.2	1,172.0	1,132.1	1,286.7	4,733.0	3.3x	0.39	0.39	0.40	0.41	1.59	19.8x

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**PJC Estimates vs.
Consensus**

We expect ZTS to report Q3 results that meet or slightly beat consensus estimates. We are currently projecting 3Q13 EPS of \$0.34 on revenues of \$1,070 MM, which is in-line with consensus estimates. We are projecting operating margin expansion of 125 bps y/y to 25.69%, which is primarily driven by SG&A and R&D leverage. Our revenue estimate is driven by the following regional y/y growth expectations:

- U.S. revenues to increase 6.0% to \$475 MM,
- EuAfME revenues to increase 4.0% to \$251 MM,
- CLAR revenues to increase 5.0% to \$173 MM, and
- APAC revenues to increase 4.0% to \$172 MM

We believe it is important to note the U.S. revenue segment faces a relatively easy y/y comp of 2.3% from 3Q12, which gives us confidence in our 6% U.S. growth assumption given improving livestock trends. We remain confident that the U.S. cattle market is improving, which is favorable for ZTS as ~40% of revenues are attributable to the U.S. and cattle accounted for 32% of revenues in 2Q13.

Exhibit 1

PJC ESTIMATES VS. CONSENSUS

\$'s in millions, except per share

<u>ZTS 3Q13 Estimates vs. Consensus</u>			<u>ZTS FY13 Estimates</u>	
	<u>Revenues</u>	<u>EPS</u>	<u>Revenue</u>	<u>EPS</u>
Guidance			\$4,425 - \$4,525	\$1.36 - \$1.42
PJC	\$1,070	\$0.34	\$4,496	\$1.40
Street	\$1,067	\$0.34	\$4,494	\$1.40

Source: Piper Jaffray estimates, FactSet, Company reports

Income Statement (\$ in MM, except per share)

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Period	FY09	FY10	FY11	1Q12	2Q12	3Q12	4Q12	FY12	1Q13	2Q13	3Q13E	4Q13E	FY13E	1Q14E	2Q14E	3Q14E	4Q14E	FY14E	FY15E
Ending	12/31/09	12/31/10	12/31/11	3/31/12	6/30/12	9/30/12	12/31/12	12/31/12	3/31/13	6/30/13	9/30/13	12/31/13	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	12/31/14	12/31/15
Revenues	\$2,760.0	\$3,582.0	\$4,233.0	\$1,047.0	\$1,094.0	\$1,019.0	\$1,176.0	\$4,336.0	\$1,090.0	\$1,114.0	\$1,070.4	\$1,221.4	\$4,495.8	\$1,142.2	\$1,172.0	\$1,132.1	\$1,286.7	\$4,733.0	\$4,982.9
Change, yr/yr		29.8%	18.2%	6.5%	1.9%	-2.9%	4.3%	2.4%	4.1%	1.8%	5.0%	3.9%	3.7%	4.8%	5.2%	5.8%	5.3%	5.3%	5.3%
Change, qtr/qtr				-7.1%	4.5%	-6.9%	15.4%		-7.3%	2.2%	-3.9%	14.1%		-6.5%	2.6%	-3.4%	13.7%		
Cost of sales	1,001.0	1,318.0	1,581.0	388.0	382.0	352.0	\$427.0	1,549.0	398.0	400.0	377.3	431.2	1,606.5	411.2	416.1	387.7	440.7	1,655.7	1,718.2
Gross Profit	1,759.0	2,264.0	2,652.0	659.0	712.0	667.0	749.0	2,787.0	692.0	714.0	693.1	790.3	2,889.3	731.0	756.0	744.3	846.0	3,077.3	3,264.7
Gross Margin	63.73%	63.20%	62.65%	62.94%	65.08%	65.46%	63.69%	64.28%	63.49%	64.09%	64.75%	64.70%	64.27%	64.00%	64.50%	65.75%	65.75%	65.02%	65.52%
SG&A	1,057.0	1,365.0	1,447.0	331.0	351.0	330.0	440.0	1,452.0	322.0	339.0	326.5	406.1	1,393.6	334.1	355.7	341.3	411.7	1,442.9	1,502.5
R&D	365.0	411.0	407.0	93.0	91.0	94.0	121.0	399.0	90.0	91.0	93.7	113.0	387.6	93.1	93.8	93.4	117.1	397.3	403.3
Amortization of intangibles	16.0	17.0	20.0	4.0	3.0	4.0	4.0	15.0	4.0	3.0	3.0	3.0	13.0	3.5	3.5	3.5	3.5	14.0	14.0
Restructuring	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other expenses/(income)	(1.0)	(25.0)	(28.0)	(6.0)	(7.0)	(10.0)	2.0	(21.0)	2.0	(3.0)	(5.0)	(5.0)	(11.0)	(7.0)	(7.0)	(7.0)	(7.0)	(28.0)	(32.0)
Total operating expenses	1,437.0	1,768.0	1,846.0	422.0	438.0	418.0	567.0	1,845.0	418.0	430.0	418.1	517.1	1,783.2	423.7	446.0	431.2	525.3	1,826.2	1,887.8
Adj. Operating Income	322.0	496.0	806.0	237.0	274.0	249.0	182.0	942.0	274.0	284.0	274.9	273.2	1,106.1	307.3	310.0	313.1	320.7	1,251.1	1,376.8
Adj. Operating Margin	11.67%	13.85%	19.04%	22.64%	25.05%	24.44%	15.48%	21.73%	25.14%	25.49%	25.69%	22.36%	24.60%	26.91%	26.45%	27.66%	24.92%	26.43%	27.63%
Interest expense	26.0	37.0	36.0	8.0	8.0	7.0	8.0	31.0	22.0	32.0	30.5	30.5	115.0	31.5	31.5	31.5	31.5	126.0	120.0
Income before taxes	296.0	459.0	770.0	229.0	266.0	242.0	174.0	911.0	252.0	252.0	244.4	242.7	991.1	275.8	278.5	281.6	289.2	1,125.1	1,256.8
Pretax Margin	10.72%	12.81%	18.19%	21.87%	24.31%	23.75%	14.80%	21.01%	23.12%	22.62%	22.84%	19.87%	22.05%	24.15%	23.76%	24.88%	22.47%	23.77%	25.22%
Income taxes	108.0	183.0	264.0	76.0	90.0	89.0	117.0	372.0	73.0	74.0	72.1	72.8	291.9	81.4	82.2	83.1	85.3	331.9	370.8
Tax Rate	36.49%	39.87%	34.29%	33.19%	33.83%	36.78%	67.24%	40.83%	28.97%	29.37%	29.50%	30.00%	29.45%	29.50%	29.50%	29.50%	29.50%	29.50%	29.50%
Net Income	188.0	276.0	506.0	153.0	176.0	153.0	57.0	539.0	179.0	178.0	172.3	169.9	699.2	194.4	196.3	198.5	203.9	793.2	886.1
less: net income attributable to noncont	(1.0)	1.0	3.0	1.0	0.0	(1.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income attributable to Zoetis	189.0	275.0	503.0	152.0	176.0	154.0	57.0	539.0	179.0	178.0	172.3	169.9	699.2	194.4	196.3	198.5	203.9	793.2	886.1
Net Margin	6.85%	7.68%	11.88%	14.52%	16.09%	15.11%	4.85%	12.43%	16.42%	15.98%	16.10%	13.91%	15.55%	17.02%	16.75%	17.54%	15.84%	16.76%	17.78%
Diluted EPS	\$0.38	\$0.55	\$1.01	\$0.30	\$0.35	\$0.31	\$0.11	\$1.08	\$0.36	\$0.36	\$0.34	\$0.34	\$1.40	\$0.39	\$0.39	\$0.40	\$0.41	\$1.59	\$1.77
Diluted Shares	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.0	500.1	500.2	500.0	500.0	500.1	500.0	500.0	500.0	500.0	500.0	500.0
Dividend			\$0.83	\$0.104	\$0.020	\$0.002	\$0.000	\$0.13	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.065	\$0.065	\$0.065	\$0.065	\$0.26	\$0.26
Dividend yield									0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Payout			82.7%	34.2%	5.7%	0.6%	0.0%	11.7%	0.0%	18.5%	18.9%	19.1%	14.0%	16.7%	16.6%	16.4%	15.9%	16.4%	14.7%
Margin Analysis:																			
Cost of sales	36.27%	36.80%	37.35%	37.06%	34.92%	34.54%	36.31%	35.72%	36.51%	35.91%	35.25%	35.30%	35.73%	36.00%	35.50%	34.25%	34.25%	34.98%	34.48%
SG&A	38.30%	38.11%	34.18%	31.61%	32.08%	32.38%	37.41%	33.49%	29.54%	30.43%	30.50%	33.25%	31.00%	29.25%	30.35%	30.15%	32.00%	30.49%	30.15%
R&D	13.22%	11.47%	9.61%	8.88%	8.32%	9.22%	10.29%	9.20%	8.26%	8.17%	8.75%	9.25%	8.62%	8.15%	8.00%	8.25%	9.10%	8.40%	8.09%
Total operating expenses	52.07%	49.36%	43.61%	40.31%	40.04%	41.02%	48.21%	42.55%	38.35%	38.60%	39.06%	42.34%	39.66%	37.09%	38.05%	38.09%	40.83%	38.58%	37.89%
Depreciation and amortization	3.73%	3.41%	3.24%	3.14%	3.38%	3.63%	2.56%	3.16%	3.21%	3.41%	3.25%	3.25%	3.28%	3.30%	3.30%	3.30%	3.30%	3.30%	3.30%
Yr/Yr Growth:																			
Cost of Sales		31.7%	20.0%	5.4%	-10.5%	-9.7%	7.8%	-2.0%	2.6%	4.7%	7.2%	1.0%	3.7%	3.3%	4.0%	2.8%	2.2%	3.1%	3.8%
Gross Profit		28.7%	17.1%	7.2%	10.0%	1.2%	2.5%	5.1%	5.0%	0.3%	3.9%	5.5%	3.7%	5.6%	5.9%	7.4%	7.1%	6.5%	6.1%
SG&A		29.1%	6.0%	-1.2%	-2.2%	0.3%	3.8%	0.3%	-2.7%	-3.4%	-1.1%	-7.7%	-4.0%	3.8%	4.9%	4.6%	1.4%	3.5%	4.1%
R&D		12.6%	-1.0%	-6.1%	-9.0%	-4.1%	10.0%	-2.0%	-3.2%	0.0%	-0.4%	-6.6%	-2.8%	3.4%	3.0%	-0.3%	3.6%	2.5%	1.5%
Adjusted Operating Income		54.0%	62.5%	28.8%	46.5%	6.4%	-9.5%	16.9%	15.6%	3.6%	10.4%	50.1%	17.4%	12.2%	9.1%	13.9%	17.4%	13.1%	10.1%
Income before taxes		55.1%	67.8%	30.9%	49.4%	7.6%	-9.4%	18.3%	10.0%	-5.3%	1.0%	39.5%	8.8%	9.5%	10.5%	15.2%	19.2%	13.5%	11.7%
Net income attributable to Zoetis		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.8%	1.1%	11.9%	198.0%	29.7%	8.6%	10.3%	15.2%	20.0%	13.4%	11.7%
Diluted EPS		45.5%	82.9%	25.6%	54.4%	5.5%	-53.3%	7.2%	17.7%	1.1%	11.9%	198.0%	29.7%	8.7%	10.3%	15.2%	20.0%	13.5%	11.7%

Source: Company reports and Piper Jaffray & Co. Current disclosure information for this company can be found at <http://www.piperjaffray.com/researchdisclosures>.

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R: Resuming Coverage
T: Transferring Coverage
D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
N: Neutral
UW: Underweight
NA: Not Available
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	336	57.05	68	20.24
HOLD [N]	227	38.54	12	5.29
SELL [UW]	26	4.41	0	0.00

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