

Zoetis Inc.

## Market Improves; Patience on Margin

**Improving macro conditions and new products drove top-line:** ZTS delivered a solid top-line beat of 9% ex-FX growth, with better-than-expected results in all regions. US cattle improved as anticipated, with positive trends in cattle placement in Sept. and forward. We expect livestock, and in particular, cattle, to be a tailwind through 2014. Companion animal was also strong. Western Europe and Australia remain challenging, though growth from other regions more than offset the weakness. New products launches also aided growth across regions.

**Patience needed for margin improvement:** Despite the top-line beat, ZTS may have surprised some with an in-line EPS from higher SG&A spending. Gross margin was down YoY but up QoQ. SG&A spending rose \$20M QoQ and \$30M YoY; the increase in spending was due to higher promotional activities in Q3 with the parasiticide season (highlighted by management during the Q2 call). The increase was higher than Street expectations and raised some questions on whether ZTS will be able to deliver on margin improvement over time. ZTS's 9-mos SG&A expense ratio decreased by 120 bps YoY at 30.8% vs. 32.0% in 2012, indicating relatively flat spending despite mid single-digit revenue growth. Despite the encouraging trends in margins compared to last year, we do admit the caveat of comparing to extrapolated historical data and believe 2014 will be a better year to assess ZTS's ability to drive margin expansion as an independent entity. By region, operating margin widened by 6 pts in the US driven by price and mix, but narrowed by 2 pts OUS due to competition, unfavorable product and geographic mix, as well as timing of promotions.

**Key thesis on growth and margin unchanged:** We are increasing our FY13 sales forecast by \$30M to \$4.52B as macro conditions improve through the end of the year, and raising our EPS estimate by \$0.01 to \$1.41. We believe ZTS is on track to deliver mid single-digit revenue growth with the majority come from organic growth and a small fraction from complementary acquisitions, and double-digit operating income growth with margin improvement over time.

### ZTS: Quarterly and Annual EPS (USD)

	2012		2013		2014		Change y/y		
FY Dec	Actual	Old	New	Cons	Old	New	Cons	2013	2014
Q1	0.30A	0.36A	0.36A	0.36A	0.38E	0.40E	0.39E	20%	11%
Q2	0.35A	0.36A	0.36A	0.36A	0.41E	0.41E	0.41E	3%	14%
Q3	0.31A	0.34E	0.34A	0.34E	0.40E	0.38E	0.40E	10%	12%
Q4	0.11A	0.34E	0.35E	0.34E	0.43E	0.41E	0.41E	218%	17%
Year	1.08A	1.40E	1.41E	1.40E	1.62E	1.60E	1.62E	31%	13%
P/E	28.9		22.2			19.5			

Source: Barclays Research.

Consensus numbers are from Thomson Reuters

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PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 3.

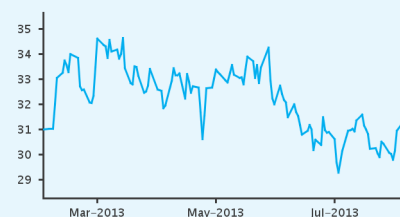
Stock Rating	<b>EQUAL WEIGHT</b>
	Unchanged
Industry View	<b>POSITIVE</b>
	Unchanged
Price Target	<b>USD 35.00</b>
	Unchanged

Price (05-Aug-2013)	USD 31.25
Potential Upside/Downside	+12%
Tickers	ZTS

Market Cap (USD mn)	28156
Shares Outstanding (mn)	500.00
Free Float (%)	99.93
52 Wk Avg Daily Volume (mn)	5.6
Dividend Yield (%)	0.2
Return on Equity TTM (%)	17.82
Current BVPS (USD)	1.60

Source: FactSet Fundamentals

Price Performance	Exchange-NYSE
52 Week range	USD 35.42-28.97



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

### U.S. Major Pharmaceuticals

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## U.S. Major Pharmaceuticals

Industry View: POSITIVE

## Zoetis Inc. (ZTS)

Stock Rating: EQUAL WEIGHT

Income statement (\$mn)	2012A	2013E	2014E	2015E	CAGR
Revenue	4,336	4,523	4,776	5,024	5.0%
EBITDA (adj)	1,079	1,259	1,400	1,572	13.4%
EBIT (adj)	942	1,113	1,254	1,418	14.6%
Pre-tax income (adj)	911	999	1,143	1,312	12.9%
Net income (adj)	539	702	804	927	19.8%
EPS (adj) (\$)	1.08	1.41	1.60	1.85	19.7%
Diluted shares (mn)	500.0	500.2	500.2	500.2	0.0%
DPS (\$)	N/A	0.26	0.31	0.37	N/A

Margin and return data	Average				
EBITDA (adj) margin (%)	24.9	27.8	29.3	31.3	28.3
EBIT (adj) margin (%)	21.7	24.6	26.3	28.2	25.2
Pre-tax (adj) margin (%)	21.0	22.1	23.9	26.1	23.3
Net (adj) margin (%)	12.4	15.5	16.8	18.5	15.8
ROIC (%)	6.2	17.5	15.5	17.6	14.2
ROA (%)	8.6	11.4	11.4	12.6	11.0
ROE (%)	13.3	27.2	44.5	44.2	32.3

Balance sheet and cash flow (\$mn)	CAGR				
Tangible fixed assets	4,409	4,574	5,206	5,551	8.0%
Intangible fixed assets	1,853	1,875	1,856	1,838	-0.3%
Cash and equivalents	317	581	1,049	1,296	59.9%
Total assets	6,262	6,449	7,062	7,389	5.7%
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	5,214	5,254	5,292	33.6%
Net debt/(funds)	265	3,069	2,601	2,354	107.1%
Shareholders' equity	4,041	1,235	1,808	2,096	-19.7%
Change in working capital	273	249	550	-139	N/A
Cash flow from operations	454	564	794	1,015	30.8%
Capital expenditure	-126	-170	-170	-181	N/A
Free cash flow	328	394	624	834	36.5%

Valuation and leverage metrics	Average				
P/E (adj) (x)	28.9	22.2	19.5	16.9	21.9
EV/EBITDA (adj) (x)	14.7	14.8	13.0	11.4	13.5
P/BV (x)	3.9	12.7	8.6	7.5	8.2
Dividend yield (%)	N/A	0.8	1.0	1.2	1.0
Total debt/capital (%)	12.6	74.7	66.9	63.5	54.4

Selected operating metrics	Average				
SG&A/sales (%)	33.5	31.3	30.5	29.5	31.2
R&D/sales (%)	9.2	8.6	8.5	8.3	8.6
R&D growth (%)	-2.0	-2.9	4.9	2.2	0.6
SG&A growth (%)	0.3	-2.5	2.9	1.8	0.6

Price (05-Aug-2013) USD 31.25  
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.

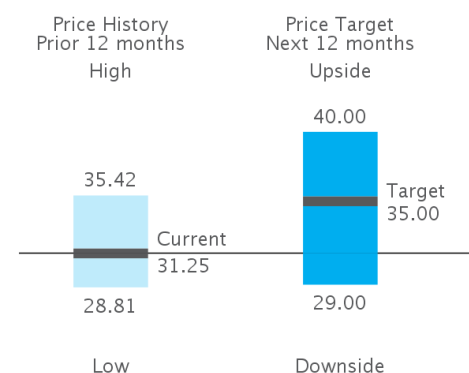
Upside case USD 40.00

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 25x 2014E EPS.

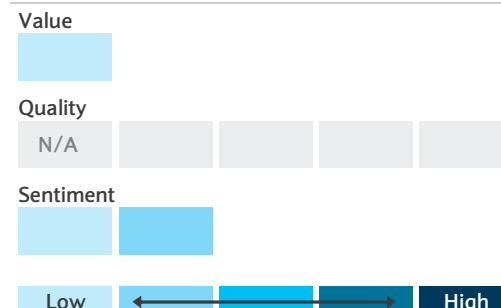
Downside case USD 29.00

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 18x 2014E EPS.

## 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

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Zoetis Inc. (ZTS, 05-Aug-2013, USD 31.25), Equal Weight/Positive, A/C/D/J/K/L/M/O

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Zoetis Inc. (ZTS)		

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USD 31.25 (05-Aug-2013)

Stock Rating

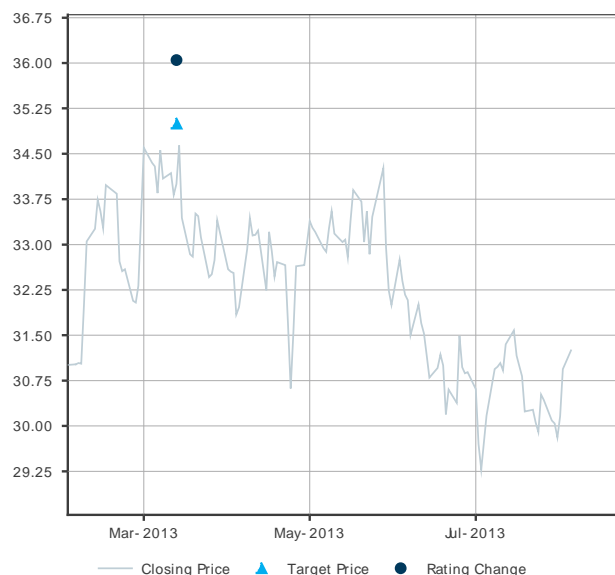
Industry View

EQUAL WEIGHT

POSITIVE

## Rating and Price Target Chart - USD (as of 05-Aug-2013)

Currency=USD


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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 22x our FY2014E EPS of \$1.60.

**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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