

Zoetis, Inc.

(ZTS - \$32.48)

May 22, 2013

Company Update **Note**

Medical Devices & Supplies

Strong Buy
\$41.00

Trading Data:

Last Price (5/22/2013)	\$32.48
52-Week High (3/14/2013)	\$35.42
52-Week Low (4/24/2013)	\$30.42
Market Cap. (MM)	\$16,240
Shares Out. (MM)	500
3 Month Avg. Daily Vol. (MM)	1.612

Earnings Estimates: (\$ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY14E	0.35	0.40	0.37	0.38	1.50
FY13E	0.36A	0.35	0.32	0.33	1.36
FY12A	0.30	0.35	0.30	0.12	1.08
FY11A	0.24	0.22	0.29	0.24	1.00

Valuation:

Multiple	Curr. FY	Next FY	Next FY @ PT
P/E	24.0	21.6	27.3
EV / EBITDA	14.9	13.3	16.4
EV / Revs.	4.2	3.8	4.7

Source: CL King & Associates estimates

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See required disclosures at the end of report.

Pfizer Initiates Exchange Offer to Distribute Its Zoetis Shares

- Pfizer (PFE: NR) announced an exchange offer this morning in which shareholders can elect to exchange “some, all, or none” of their Pfizer shares for shares of Zoetis currently owned by Pfizer.
- The exchange offer is designed to enable Pfizer shareholders to receive shares of Zoetis at a 7% discount. The exchange ratio should be determined by 4:30 p.m. June 19.
- In our view, the share exchange should reduce the risk of excessive selling pressure as Pfizer disposes of its 80% ownership position in Zoetis, compared to other possible methods.
- We believe Zoetis is attractively priced at present and we reiterate our Strong Buy rating.

Pfizer announces exchange offering: Pfizer announced this morning it plans to initiate an exchange offer in which its shareholders can elect to exchange “some, all, or none” of their Pfizer shares for shares of Zoetis currently owned by Pfizer. Pfizer expects this to be a tax-free exchange offer for participating Pfizer shareholders in the U.S.

The exchange offer is structured to enable Pfizer shareholders to receive shares of Zoetis at a 7% discount: The exchange offer is structured so that Pfizer shareholders can exchange their Pfizer common for Zoetis common at a 7% discount. However, the exchange is subject to an upper limit of 0.9898 shares of Zoetis common per share of Pfizer common. Also, if the upper limit of 0.9898 is not reached, for each \$100.00 of shares of Pfizer common stock accepted in the exchange offer, tendering shareholders would receive approximately \$107.52 of Zoetis common.

Exchange ratio based on the current stock prices is close to the 0.9898 limit: Based on the Pfizer and Zoetis share prices as of 11:43 a.m. of \$29.68 and \$32.48, respectively, we estimate the current exchange ratio is approximately 0.9826. This is close to the 0.9898 upper limit. Our computations are shown in Table 1.

Table 1: Estimate of exchange ratio based on current prices

Line No.	Item	Amount	Computation
L. 1	Current Zoetis price	\$32.48	
L. 2	Intended discount for those who participate in the exchange	7.0%	
L. 3	Discounted Zoetis value per share	\$30.21	$L. 3 = L. 1 * (1 - L. 2)$
L. 4	Current Pfizer share price	\$29.68	
L. 5	Exchange ratio based on current prices	0.9826	$L. 5 = (L. 4 / L. 3)$

Source: CL King & Associates estimates

The exchange ratio will be determined June 19: The values of the Pfizer and Zoetis shares used in calculating the exchange ratio will be determined by computing the volume-weighted average share price of Pfizer and the volume-weighted average share price of Zoetis during three consecutive trading days on June 17, 18 and 19. Pfizer plans to announce the exchange ratio in a press release by 4:30 p.m. on June 19.

Additional details: Pfizer owns about 401 million shares of Zoetis common, or about 80% of the company. The completion of the share exchange is dependent on the distribution of at least 160.4 million shares of Zoetis common in exchange for Pfizer common stock. Alternatively, if this exchange offer is oversubscribed the exchange will be prorated.

If the exchange is undersubscribed, Pfizer would continue to own some ZTS shares. If Pfizer ends up owning ZTS shares after the offering, it may conduct additional exchange offers or issue a special dividend of Zoetis shares to all Pfizer shareholders in order to complete the disposition of all its ZTS shares.

In our view, this share exchange should reduce the risk of excessive selling pressure as Pfizer disposes of its ownership of Zoetis: In our view, the majority of the Pfizer shareholders who participate in the exchange should be doing so with the intention that they plan to retain the Zoetis shares they receive for a reasonable period of time. We believe this should help reduce the probability of excessive selling pressure that could occur if Pfizer were to simply issue a special dividend of all of 401 million ZTS shares to its shareholders.

Investment thesis and valuation: We believe Zoetis is well positioned to deliver stable, predictable and sustainable growth. We forecast the five-year compound annual growth in organic revenues and EPS should be at least 6% and 10%, respectively. Also, we view Zoetis as an excellent investment in the growth of the animal health industry. Zoetis has many of the characteristics of the other high-quality, growing animal health companies we follow. These include stable revenue growth, high margins and returns, and operations within an oligopolistic animal health industry segment. We project the global animal pharmaceutical industry should grow 6% annually over the next five years, driven by both the production animal and companion animal sectors. We believe growth in developing economies and increasing global demand for protein should be an important source of the company's long-term growth. Emerging markets currently contribute 27% of Zoetis' revenues.

We believe in the current sluggish macroeconomic environment investors will continue to be attracted to companies like Zoetis that are able to deliver steady revenue and earnings growth driven by unit growth and pricing power adequate to offset cost inflation. Furthermore, we anticipate healthcare investors will continue to be attracted to companies that are insulated from reimbursement pressure from the government and other third parties. We believe Zoetis' industry-leading position and high market share should facilitate its growth and help mitigate risk. In addition, we believe the company's high level of R&D spending and large direct sales and marketing organization help create sustainable competitive advantages. Valuation data is in the table below.

Table 2: Valuation Multiples for Zoetis

Item	2012PF	2013E	2014E
Stock price	\$32.48	\$32.48	\$32.48
Revenues (in 1,000's)	\$4,336,000	\$4,562,840	\$4,878,018
EBITDA (in 1,000's)	\$1,105,000	\$1,281,428	\$1,406,543
EPS - GAAP	\$1.01	\$1.29	\$1.42
EPS adj to add back amortization exp.	\$1.08	\$1.36	\$1.50
P / E ratio - based on adj. EPS	30.1 x	24.0 x	21.6 x
EV / EBITDA ratio	17.6 x	14.9 x	13.3 x
EV / Revenue ratio	4.5 x	4.2 x	3.8 x
ROA	9.2%	11.0%	12.0%
ROE	22.2%	49.2%	38.7%
Enterprise value computation:			
Equity market value (in 1,000's)	\$16,240,000	\$16,501,635	\$16,667,272
Total debt (in 1,000's)	\$3,640,000	\$3,340,000	\$2,540,000
Cash (in 1,000's)	\$484,000	\$730,552	\$544,019
Enterprise value (in 1,000's)	\$19,396,000	\$19,111,084	\$18,663,252

Source: CL King & Associates estimates

Risks

Regulators could impose new restrictions on the use of antibiotics in production animals due to concerns about antimicrobial resistance in humans. Similarly, changes in consumer views of products from animals treated with antibiotics could also impact Zoetis' business. The production animal and companion animal markets are sensitive to the economy, so if the economy weakens materially Zoetis' revenues and income may be lower than we project. Furthermore, severe weather conditions such as drought, which can result in higher grain and feed prices and reduced available grazing pasture, could result in a reduction of beef and dairy cattle herds. Within our financial forecasts we project Zoetis' margins should expand over the next several years. There is a risk the company may not be as successful in improving margins as much as we expect. Also, Zoetis may not be as effective as we project in managing its operations and expenses during its process of fully separating from Pfizer. There is a risk the pending exchange offer in which Pfizer shareholders can exchange their Pfizer shares for shares of Zoetis could cause volatility in the stock.

Previous research update – 04/30/13

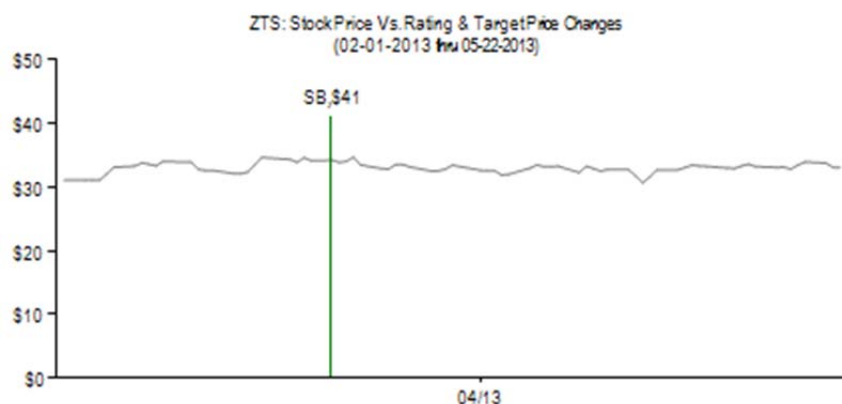
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Additional information available upon request.

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RATINGS INFORMATION**Rating and Price Target Change History***3 Year Rating Change History*

Date	Rating	Closing Price, (\$)
03/11/2013	Strong Buy (SB)	34.18

3 Year Price Change History

Date	Target Price	Closing Price, (\$)
03/11/2013	41.00	34.18

Source: CL King & Associates, Created by: www.ResearchMaestro.net

*Note: Prior to 02/01/2011 Buy was Accumulate
Prior to 02/01/2011 Sell was Underperform*

CL King Rating System*		% of Companies Under Coverage With This Rating	% of Companies for which CL King has performed services for in the last 12 months	
			Investment Banking	Brokerage
Strong Buy (SB)	Analyst believes shares will appreciate by 20% or more over the next 6-12 months and should significantly outperform the broader market averages. Analyst believes the risk of long-term capital impairment is below-average.	17.39%	0.00%	2.17%
Buy (B)	Analyst believes shares will appreciate in a range of 10% to the upper teens over the next 6-12 months and will outperform the broader capital market averages. Analyst believes the risk of long-term capital impairment is below-average, but not as low as it is for Strong Buy.	36.96%	1.45%	0.72%
Neutral (N)	Analyst believes the current stock price fairly discounts the company's prospects over the next 6-12 months, give or take 10%, and will trade in-line with the broader market averages. Analyst believes the risk of permanent capital impairment is about average.	44.93%	0.72%	2.17%
Sell (S)	Analyst expects the stock price to decline 10% or more over the next 6-12 months and to underperform the broader market averages.	0.72%	0.00%	0.00%

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