

# Zoetis

(ZTS-NYSE)

**Stock Rating:** Outperform  
**Stock Price:** \$31.59  
**Target Price:** \$38.00

Monday, November 11, 2013  
Pharmaceuticals

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## Novartis Divestiture of Diagnostics Unit Could Be Incrementally Positive for Zoetis

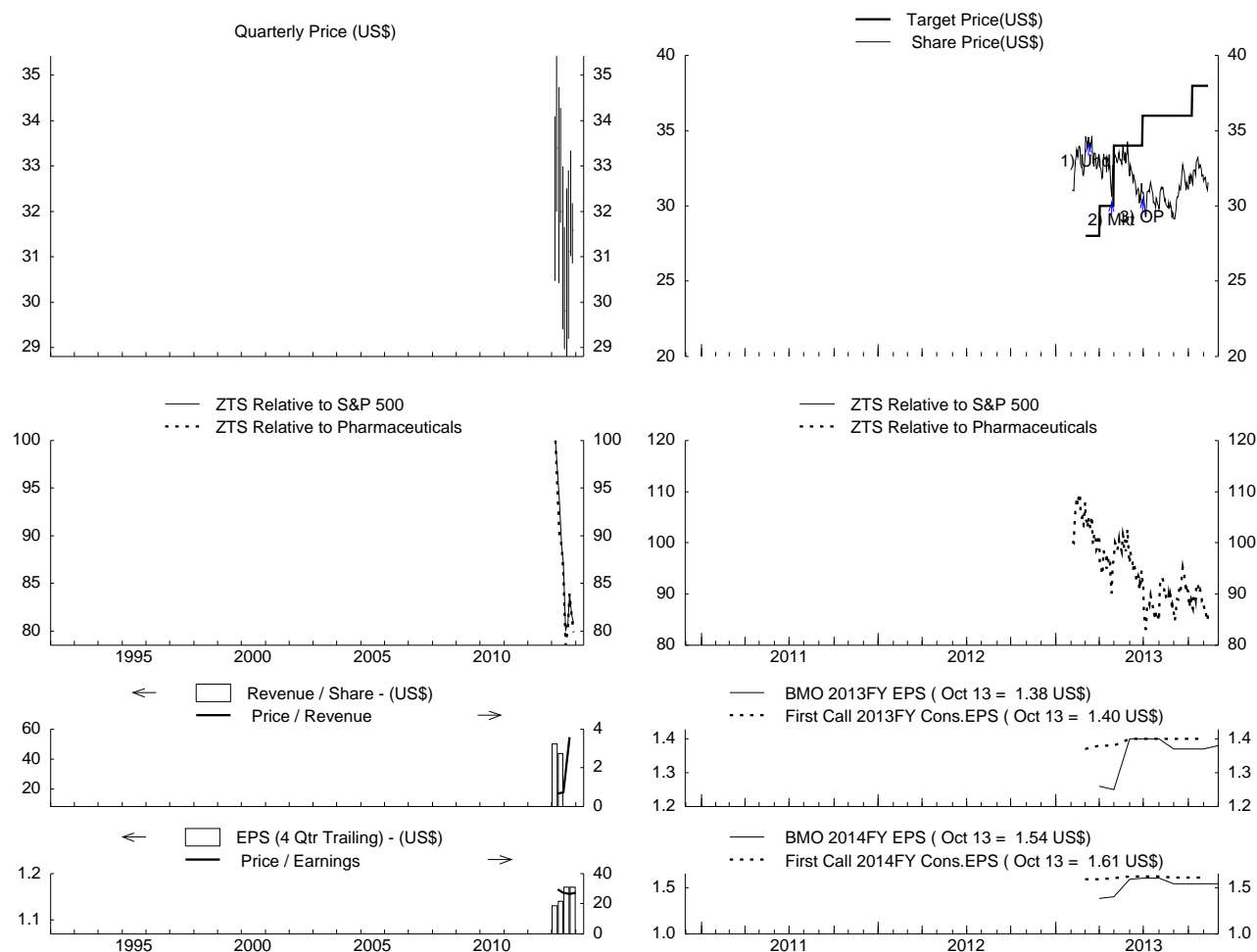
This morning, Novartis, (NVS, Not Rated) announced a definitive agreement to divest its blood transfusion diagnostics unit to Grifols (GRFS-US, Not Rated) for US\$1.675 billion. The transaction is expected to be completed in the first half of 2014.

### Our View:

- Positive. The divestiture could indicate that Novartis does not plan to spin-out or split off its Animal Health business in the near future. We believe that concerns about either Novartis and/or Merck (MRK, \$46.80; Outperform) spinning out their respective Animal Health businesses have been weighing on ZTS shares. The rationale is that if this were to happen, Zoetis would lose some of its “uniqueness” value and would have to compete for investor dollars with these new assets.
- However, we continue to believe that Zoetis is undervalued on its own merits. Despite some quarterly fluctuations, the company is performing well: year-to-date revenues have grown 4.7% (6% ex-Fx), while total OPEX has increased 2.5% (4% ex-Fx) year to date; this should be in line with most investors’ expectations. Importantly, Zoetis is delivering this performance while making the investments needed to operate as an independent company. Therefore, we continue to believe that although possible spin-outs of the Animal health businesses of Merck and Novartis could steal the spotlight from Zoetis, they could also highlight the company’s relative strengths given such activities/investments.
- We forecast that Zoetis should be able to achieve its 2013 guidance. Looking further ahead, we expect Zoetis to grow revenues by a CAGR of 4.5%-5% as total OPEX grows at a slower pace. As such we expect operating margins to increase from 24.4% in 2013 to 30% in 2017 and ~35% in 2023. Product mix and increased contribution from the Companion Animal segment should also support margin expansion.
- We value ZTS shares at \$38 based on DCF: 2.5% terminal growth rate, 8.3% discount rate supported by 23x 2015 EPS of \$1.77, based on 2013-2016 EPS CAGR of 13%, and 2014-2013 OCF CAGR of 10%. We reiterate our Outperform rating.

This report was prepared by an analyst(s) employed by BMO Nesbitt Burns Inc. For disclosure statements, including the Analyst's Certification, please refer to pages 2 to 6.

## Zoetis Inc. (ZTS)



FYE (Dec.)	EPS US\$	P/E Hi - Lo	DPS US\$	Yield% Hi - Lo	Payout %	BV US\$	P/B Hi - Lo	ROE %	ZTS - Rating as of 1-Feb-13 = NR		
Range*:		na na		NC			>15 >15		Date	Rating Change	Share Price
Current*	1.17	27.1	0.26	0.8	22	1.6	19.8	>50	1 7-Mar-13	NR to Und.	\$34.56
									2 24-Apr-13	Und.to Mkt	\$30.62
									3 27-Jun-13	Mkt to OP	\$30.87

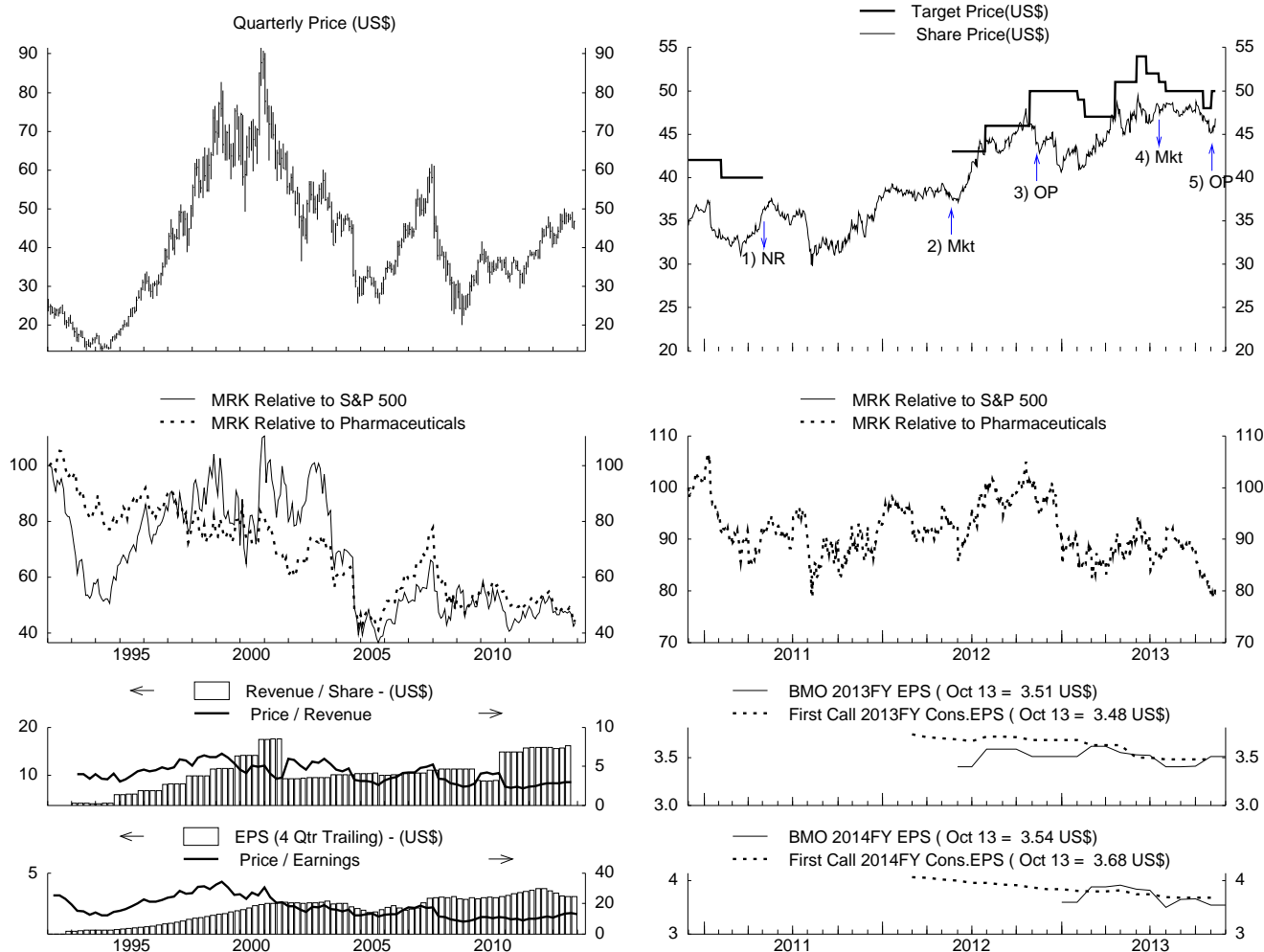
\* Current EPS is the 4 Quarter Trailing to Q3/2013.

\* Valuation metrics are based on high and low for the fiscal year.

\* Range indicates the valuation range for the period presented above.

Last Price ( November 8, 2013): \$31.59  
Sources: IHS Global Insight, Thomson Reuters, BMO Capital Markets.

## Merck &amp; Co. Inc. (MRK)



FYE (Dec.)	EPS US\$	P/E Hi - Lo	DPS US\$	Yield% Hi - Lo	Payout %	BV US\$	P/B Hi - Lo	ROE %
1992	1.06	25.3 18.1	0.45	2.4 1.7	43	2.2	12.2 8.8	
1993	1.17	19.3 11.6	0.53	3.9 2.3	45	4.0	5.6 3.4	38
1994	1.19	15.7 11.2	0.57	4.3 3.0	48	4.5	4.2 3.0	28
1995	1.35	23.6 12.8	0.64	3.7 2.0	48	4.8	6.7 3.6	29
1996	1.56	25.6 17.1	0.76	2.8 1.9	49	5.0	8.0 5.4	32
1997	1.87	27.4 19.0	0.85	2.4 1.7	46	5.3	9.7 6.7	37
1998	2.15	35.6 20.9	1.02	2.3 1.3	48	5.4	14.1 8.3	40
1999	2.45	33.8 23.5	1.10	1.9 1.3	45	5.7	14.5 10.1	44
2000	2.90	31.6 17.0	1.29	2.6 1.4	44	6.4	14.2 7.7	48
2001	3.04	29.9 17.7	1.33	2.5 1.5	44	7.1	12.9 7.6	45
2002	2.98	21.8 12.2	1.36	3.7 2.1	46	8.1	8.0 4.5	39
2003	2.92	20.6 13.9	1.48	3.6 2.5	51	7.0	8.6 5.8	39
2004	2.62	18.8 9.8	1.52	5.9 3.1	58	7.8	6.3 3.3	35
2005	2.53	14.0 10.1	1.52	6.0 4.3	60	8.2	4.3 3.1	32
2006	2.52	18.4 11.1	1.52	5.4 3.3	60	8.1	5.7 3.5	31
2007	3.31	18.6 12.8	1.52	3.6 2.5	46	8.4	7.4 5.1	40
2008	3.42	18.0 6.7	1.52	6.7 2.5	44	8.9	6.9 2.6	40
2009	3.26	11.8 6.2	1.52	7.6 4.0	47	19.0	2.0 1.1	23
2010	3.42	12.2 9.0	1.52	5.0 3.7	44	17.6	2.4 1.7	19
2011	3.77	10.1 7.8	1.68	5.7 4.4	45	17.9	2.1 1.6	21
2012	3.82	12.6 9.1	1.72	4.9 3.6	45	17.5	2.7 2.0	22

Range\*:

Current\* 3.43 13.1 1.72 3.8 50 16.2 2.8 21

Growth(%):

5 Year:	0.5	2.5	14.2
10 Year:	1.0	1.5	7.2
20 Year:	5.6	6.1	10.5

\* Current EPS is the 4 Quarter Trailing to Q3/2013.

\* Valuation metrics are based on high and low for the fiscal year.

\* Range indicates the valuation range for the period presented above.

MRK - Rating as of 30-Nov-10 = OP

Date	Rating Change	Share Price
1 3-May-11	OP to NR	\$36.41
2 18-May-12	NR to Mkt	\$37.82
3 9-Nov-12	Mkt to OP	\$44.05
4 17-Jul-13	OP to Mkt	\$48.13
5 1-Nov-13	Mkt to OP	\$45.23

Last Price ( November 8, 2013): \$46.80

Sources: IHS Global Insight, Thomson Reuters, BMO Capital Markets.

## Important Disclosures

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### Company Specific Disclosure for ZTS

#### Methodology and Risks to Our Price Target

**Methodology:** DCF and P/E Multiple

**Risks:** Demand for animal health products could fluctuate and there are relatively low barriers to entry for competitors.

### Company Specific Disclosures for MRK

9 - BMO Capital Markets makes a market in this security.

#### Methodology and Risks to Our Price Target

**Methodology:** DCF: Free Cash Flow To Equity and P/E multiple.

**Risks:** Uncertainty of Phase 3 Pipeline.

### Distribution of Ratings (September 30, 2013)

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
Buy	Outperform	35.8%	20.3%	47.8%	36.7%	48.3%	52.6%
Hold	Market Perform	59.4%	13.1%	51.1%	56.9%	50.2%	41.7%
Sell	Underperform	4.9%	3.4%	1.1%	6.4%	1.5%	5.6%

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Mkt = Market Perform - Forecast to perform roughly in line with the analyst's coverage universe on a total return basis;

Und = Underperform - Forecast to underperform the analyst's coverage universe on a total return basis;

(S) = Speculative investment;

NR = No rating at this time; and

R = Restricted – Dissemination of research is currently restricted.

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