HILLIARD LYONS

Pharmaceuticals
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June 25, 2013

Zoetis, Inc.

ZTS – NYSE – Buy – 3

Rating Upgraded to Buy from Neutral

COMPANY UPDATE/RATING CHANGE
(June 25, 2013)

Key Metrics

ZTS - NYSE (Price as of 6/24/13)		$30.38
Price Target		$36.00
52-Week Range		$35.42 - $29.40
Shares Outstanding (mm)		500.0
Market Cap. ($mm)		$15,190
3-Mo. Average Daily Volume		1,611,720
Institutional Ownership		NA
Tot. Debt/Tot. Debt+Equity (3/13 pro-forma)		84.2%
ROE (2012)		NA
Book Value/Share		$1.41
Price/Book Value (6/24/13)		21.51x
Indicated Dividend / Yield	$0.26	0.9%
LTM EBITDA Margin		25.8%

EPS FY 12/31

	Pro-forma 2012	Prior 2013E	Curr. 2013E	Prior 2014E	Curr. 2014E
1Q	--	$0.36A	$0.36A	--	--
2Q	--	--	--	--	--
3Q	--	--	--	--	--
4Q	--	--	--	--	--
Year	$0.97	$1.40	$1.40		$1.60
P/E	31.3x	21.7x	21.7x		19.0x

Note: Figures exclude non-recurring items

Revenue ($mm)

	2012	Prior 2013E	Curr. 2013E	Prior 2014E	Curr. 2014E
1Q	$1,047	$1,090A	$1,090A	--	--
2Q	--	--	--	--	--
3Q	--	--	--	--	--
4Q	--	--	--	--	--
Year	$4,336	$4,500	$4,500		$4,725

Company Description: *Zoetis operates the world's largest animal health business. Zoetis is involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals. The company sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific.*

- **We are upgrading our rating on Zoetis to Buy from Neutral**. Zoetis, the former animal health unit of Pfizer, was recently separated from PFE into an independent company. ZTS is the first major participant in the global animal health business available to those interested in investing in the sector. The recent decline in the price of ZTS shares has moved the stock to a value we consider attractive.
- **Zoetis is a global leader in the development, manufacturing, and marketing of animal health medicines and vaccines**. The company's over 300 product lines focus on livestock, which includes cattle, poultry, swine, sheep, and fish, as well as companion animals. Key products are vaccines, parasiticides, anti-infectives, and other specialty products. More than 3,400 sales employees serve livestock producers and veterinarians in 70 countries. By region, sales are in the U.S. (41%), Europe/Africa/Middle East (25%), Canada/Latin America (18%), and Asia/Pacific (16%).
- **Zoetis's business has characteristics we find attractive**. These include a large and growing market, reliable revenue, a fragmented customer base of mainly cash payers, and limited impact from generics.
- **Pfizer distributed its remaining holdings in Zoetis in an exchange termed a split-off**. PFE conducted an IPO of a portion of its Zoetis holdings in February, leaving the company with 400,985,000 shares, or about 80% of Zoetis. In the split-off, shares of Pfizer were exchanged for stock in Zoetis at a discount. PFE shareholders had the option of voluntarily exchanging some or all of their PFE shares for ZTS stock. By doing so, PFE accomplished a share repurchase using ZTS stock as the transaction currency.
- **Our price target is $36 per share.** ZTS is trading at 22 times our 2013 EPS estimate. We arrive at our target by using our 2014 EPS estimate of $1.60 and assuming ZTS could at least maintain its current valuation. We have conservatively changed our suitability rating to 3 from 2.

Note Important Disclosures on Pages 11 and 12.
Note Analyst Certification on Page 11.

Strategic Alternatives for Animal Health and Nutrition

Pfizer has pursued strategic alternatives for its Animal Health and Nutrition businesses. Management noted these are strong franchises on their own, but had different objectives from the core pharmaceutical businesses. As such, their strategic direction and value to Pfizer shareholders might be maximized by a spin-off, sale, or other transaction. Separation allows the company to focus on its global pharmaceutical and consumer medicines areas. In December 2012, Pfizer completed the sale of its nutrition unit for $11.85 billion.

In February 2013, Pfizer completed an initial public offering of a portion of Zoetis. A minority stake in the unit was sold through the IPO. As part of the IPO, Pfizer exchanged Zoetis Class A common stock for Pfizer debt held by certain underwriters, who then sold the shares to the public. The stock was priced at $26 per share on the public offering. Trading began on February 1, 2013. PFE holds Zoetis Class B common stock, and retained approximately 80% ownership in the company. Class A and Class B common shares have identical voting rights except in the election of directors where Class B shares have ten votes per share while Class A shares have one. Each share of Class B Common held by Pfizer is convertible into a share of Class A. PFE subsequently distributed its remaining ownership to shareholders in a split-off transaction in which shares in Pfizer were exchanged for ZTS stock, essentially accomplishing a share repurchase.

The Animal Health Industry

The animal health industry, which includes both livestock and companion animals, is large and growing. Animal health products, excluding such items as livestock feed or pet food, accounts for an estimated $100 billion in annual revenue. The industry is composed of medicines, vaccines, diagnostic tests, medical devices, nutritional supplements, veterinary services, and pet supplies. Within this, animal medicines and vaccine are believed to make up about $22 billion in annual revenue.

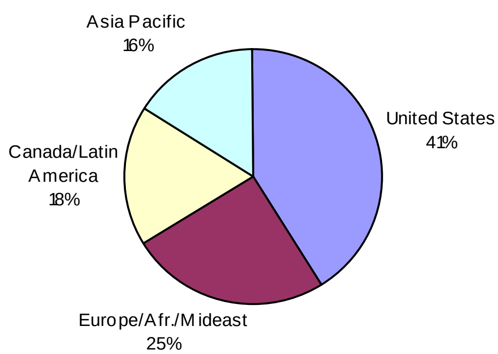
Livestock used in the production of animal protein are cattle, swine, poultry, sheep, and fish. Medicines and vaccines used in livestock make up an estimated 60% of the market. A growing global population with an improving standard of living has resulted in increased demand for animal protein and production efficiency. Animal health products are critical in order to meet this nutritional demand and ensure a safe and reliable food supply. In addition to improvements in production efficiency, these products deal with infectious disease and foodborne illness. Infectious disease can result from certain diseases or parasites. Foodborne illnesses can be traced to pathogens such as *salmonella* and *E. coli* infections in animals. Medicines and vaccines help reduce or prevent the outbreak of infectious disease and inhibit the spread to both animals and humans. Annual market growth is projected to be in the mid single-digits.

Companion animals include dogs, cats, and horses. It is felt that companion animals have a positive effect on the physical and emotional state of their owners. Pet ownership is growing globally with owners likely becoming increasingly attached to their pets. In the U.S., 62% of households owned a pet in 2012 compared to 56% in 1988. Pet owners are willing to spend for nutritious pet food and on medical care for pets. Medicines and vaccines for companion animals can extend the life of a pet and also improve the quality of life. It is estimated that these companion animal products account for about 40% of the animal medicine and vaccine market with growth also projected to be in the mid single-digits.

Overview of Zoetis

Zoetis operates the world's largest animal health business. Zoetis has been involved in the development, production, and marketing of vaccines, medicines, and diagnostic tests to prevent and treat disease in livestock and companion animals for more than 60 years. The business sells products worldwide with strong market positions in the U.S., Europe, Africa and the Middle East, Canada, Latin America, and Asia/Pacific. International operations accounted for 59% of total revenue. Sales in emerging markets such as Brazil, China, and India amounted to 26% of revenue. Zoetis' global revenue breakdown is shown in Figure 1. Products are used in the livestock species of cattle, swine, poultry, sheep, and fish. In companion animals, the company makes products for dogs, cats, and horses. Revenue for 2012 was $4.34 billion, up 2% from $4.23 billion in 2011 (See Figure 3). The business is primarily self-pay with less influence from insurance companies or government reimbursement.

Figure 1. Zoetis 2012 Worldwide Revenue Breakdown



Source: Zoetis Inc.

Zoetis has a sales organization of approximately 3,400 employees. The organization consists of a network of technical and veterinary operations specialists. These individuals market the company's diverse portfolio of more than 300 products to livestock producers and veterinarians in 70 countries. No one product or line dominates Zoetis' sales. The company's largest product line, the antibiotic ceftiofur, accounts for less than 8% of revenue with Zoetis' top ten products accounting for less than 40% of sales. The company's main product lines are shown in Figure 2. The company generally uses a direct sales model, but engages distributors in markets without a commercial presence.

Revenue from livestock products was $2.81 billion in 2012, or 65% of total revenue. Products include parasiticides used against gastrointestinal and other internal parasites as well as external parasites such as fleas and ticks. Anti-infectives guard against bacteria and infections. Feed additives provide medicine and nutrients. Other products aid in breeding or improve the efficiency of hatchery operations. Vaccines prevent respiratory, gastrointestinal, or reproductive diseases. Products for cattle amounted to an estimated $1.61 billion, or 57% of livestock products' 2012 revenue.

Companion animal products comprised about 36% of 2012 sales, or $1.53 billion. These can improve or extend the life of pets. Vaccines prevent distemper, hepatitis, respiratory disease, and influenza. Parasiticides protect against fleas, heartworms, and other parasites. Antibiotics treat skin infections and ophthalmic infections. Anti-inflammatories deal with arthritis and post-operative pain.

Figure 2. Key Products

Livestock Products

Product Line/Product	Description	Used In
Vaccines		
Bovishield	Prevent bovine infectious diseases such as diarrhea, influenza, RSV, and others	Cattle
Improvac/Improvest	Reduce boar taint	Swine
RespiSure Line	Prevent chronic pneumonia	Swine
Rispoval Line	Prevent viruses associated with cattle pneumonia and other respiratory diseases	Cattle
Parasiticides		
Cydectin	Control internal and external parasites	Cattle, Sheep
Dectomax	Treat/control internal and external parasitic infections	Cattle, Swine
Anti-Infectives		
Aureomycin	Treat wide range of respiratory, enteric, and reproductive diseases	Cattle, Poultry, Sheep, Swine
BMD	Prevent enteritis, resulting in increased weight and feed efficiency	Cattle, Poultry, Swine
Ceftiofur Line	Broad-spectrum cephalosporin antibiotic	Cattle, Horses Sheep, Swine
Draxxin	Antibiotic to treat respiratory disease and infectious conjunctivitis	Cattle, Swine
Lincomycin Line	Treat/prevent chronic repiratory disease in chickens, dysentery in swine	Swine, Poultry
Spectramast	Treat/prevent mastitis	Cattle
Terramycin	Antibiotic for treatment of infections	Cattle, Poultry, Sheep, Swine
Other		
Eazi-Breed CIDR	Progesterone releasing device to control estrus (reproductive) cycle	Cattle, Sheep
Embrex Devices	Device for in ovo hatchery detections and vaccinations	Poultry
Lutalyse	Estrus (reproductive cycle) control	Cattle, Swine

Companion Animal Products

Product Line/Product	Description	Used In
Vaccines		
Vanguard 4-way Lepto	Protect against leptospirosis bacteria	Dogs
Vanguard High Titer	Prevent canine distemper, canine hepaitis, certain canine respiratory disease, canine parainfluenza, and parvoviral enteritis	Dogs
Parasiticides		
Revolution	Protect against fleas, heartworm, mites and ticks for dogs, roundworm and hoofworm for cats	Cats, Dogs
Anti-infectives		
Clavamox/Synulox	Broad-spectrum penicillin antibiotic	Cats, Dogs
Convenia	Anti-infective for bacterial skin infections	Cats, Dogs
Terramycin	Antibiotic for ophthalmic infections	Cats, Dogs, Horses
Other		
Cerenia	Oral medication for prevention of vomiting from motion sickness	Dogs
Rimadyl	Anti-inflammatory for osteoarthritis and post-operative pain	Dogs

Source: Zoetis Inc.

Growth has been the result of organic growth and acquisitions. A strong research and development function has produced many new products. Zoetis spends between 9% and 10% of revenue on R&D. Management noted that Zoetis obtained approximately one fourth of all animal health medicine approvals by the FDA from 2004 to 2011. During that same time period the company obtained approximately one fifth of all animal health vaccine approvals by the USDA. Previously, the company introduced the *Equivac HeV* vaccine in Australia for the Hendra virus in horses and *Poulvac E.coli*, a spray vaccine against avian *E.coli* for use in the poultry industry in Europe. More recently, the USDA approved an enhanced version of the *Witness HW* heartworm antigen test for dogs and cats. The FDA has approved *Apoquel* for controlling itching and inflammation in dogs.

Key acquisitions were SmithKline Beecham Animal Health in 1995 (vaccines and companion animal products), Embrex in 2007 (poultry devices and vaccines), Alpharma (poultry, cattle, and swine products with King Pharmaceuticals), and several smaller companies. Pfizer's acquisition of Wyeth in 2009 added the Fort Dodge Animal Health products with several important vaccines for dogs, cattle, horses, and poultry.

Key Investment Characteristics

We feel Zoetis' business has several attractive characteristics. These are discussed below.

The company serves a large and growing market. As mentioned earlier, the medicines and vaccines sector of the animal health market is estimated to be approximately $22 billion in size and growing at a single-digit rate. Rising standards of living in emerging markets have resulted in higher demand for animal protein. Increased pet ownership and care provided to companion animals is on the rise. In addition to organic growth, we believe ZTS has opportunities to add to its business through acquisitions or licensing of technology.

Revenue is reliable, in our view. Though not immune to economic conditions, we believe consumption of food and other staples is a recession resistant market. For companion animals, owners seem likely to forgo other discretionary expenditures before curtailing spending on beloved pets.

Though large, Zoetis' market is fragmented. The company's broad sales network sells to individual livestock, swine, and poultry producers and to veterinarians and pet owners in 70 countries. With fewer large customers, there is less pressure on pricing from buyers purchasing large volumes of products.

No one product or line of business dominates the company's revenue. Zoetis has a diverse portfolio of more than 300 products. The company's top ten products account for less than 40% of sales. With numerous products generating relatively small amounts of revenue, there is less to attract new entrants.

The company's large, established sales force presents a barrier to entry. The ZTS direct sales force has existing relationships with livestock producers and veterinarians, which would be expensive to duplicate. The global operations of the company also provide scale that offers a formidable obstacle to potential competitors.

Customers are mainly cash payers. As there are no large government or state-controlled entities involved in the purchase of animal care products, issues of reimbursement are not present. This also reduces the likelihood of a large purchaser imposing its pricing structure on companies such as Zoetis.

We believe generic competition has a limited impact despite patent expirations. Approximately 80% of Zoetis' revenue is from products that were not patented or do not have market exclusivity. With numerous small product lines, there is less scale to attract generic producers. In addition, gross margins of over 60% are attractive but less than that of pharmaceutical companies.

Recent Results

For 2012, revenue increased 2% to $4.34 billion from $4.23 billion in 2011. Livestock revenue was up 1% at $2.81 billion while companion animal sales grew 5% to $1.53 billion. Overall organic growth of 5% was partially offset by a negative currency impact of 4%. There was a small amount of revenue from acquisitions.

U.S. sales rose 7% to $1.77 billion, mostly organic growth with a small amount from acquisitions. Domestic livestock sales were boosted by sales to the swine industry of a reformulated vaccine, products to treat infections in swine and cattle, and higher sales of medicated feed additives in swine. This was partially offset by the negative impact of the North American drought. Companion animal revenue benefited from an extended flea and tick season caused by warm weather. Sales of canine vaccines increased. Sales in Europe were up 3% in local currencies but fell 4% to $1.10 billion due to unfavorable foreign exchange. Livestock revenue benefited from higher sales of cattle parasiticides in France and the U.K. and growing demand in emerging markets. Adversely affecting livestock sales were challenging macroeconomic conditions and restrictions on antibacterials. Canada and Latin America declined 2% overall to $769 million but rose 5% in local currencies. A new formulation of a swine vaccine and marketing support for recently acquired products boosted livestock sales, partially offset by a slowdown in the cattle market in Brazil. Growth of vaccine sales in Brazil and higher parasiticides in Canada were factors in higher companion animal sales. Finally, Asia Pacific revenue was up 8% to $695 million, mainly organic growth. Livestock sales benefited from growth in Australia, China, and Japan while companion animal sales were up in Japan, among other markets.

Operating income for 2012, adjusted for non-recurring items, grew 19% as costs declined. The adjusted gross margin improved to 64.3% from 62.6% due to favorable product mix and increased operational efficiencies. Cost reduction initiatives and acquisition integration resulted in lower SG&A and R&D expenses. With adjustments and financial transactions associated with the separation, pro-forma net income was $483 million in 2012, or $0.97 per share, excluding non-recurring items.

Zoetis reported financial results for its first quarter as a standalone company separate from Pfizer. First quarter 2013 results are compared to figures a year ago if ZTS had been separate from PFE at that time. First quarter revenue increased 4% to $1.09 billion from $1.05 billion in the first quarter of 2012. Livestock revenue increased 2% to $706 million from $691 million last year. Double-digit growth was achieved in products for swine and poultry with cattle down 3%. Companion Animal sales were up 8% to $384 million versus $356 million. Products for dogs and cats grew 10% in the quarter.

Adjusted for non-recurring items, operating income rose 20% in the quarter. The gross margin was higher at 63.1% versus 62.6% as margin improvement continued. SG&A declined 3% as the company is still benefiting from acquisition-related savings and cost management, partially offset by added expenses to develop infrastructure as a standalone company. Research spending also fell 3%. Interest expense was much higher due to debt issued as part of the separation, so pretax income on the same basis increased 10%. Adjusted net income rose 18% on a lower tax rate. EPS of $0.36, excluding non-recurring items, rose from $0.30 last year and exceeded expectations of $0.33.

By geography, U.S. sales rose 7% to $454 million from $425 million a year ago. Companion Animal sales increased 13% to $209 million with some benefit from a competitor supply issue. Livestock revenue was up 2% to $245 million, impacted by some lingering effect from the North American drought last year and its impact on domestic livestock producers.

Revenue from Europe, Africa, and the Middle East was up 5% to $290 million as currency added 1% to growth. Livestock sales grew 4% to $195 million with strength in swine and poultry. Companion Animal revenue increased 8% to $95 million.

Sales in Canada and Latin America declined 1% to $171 million, but rose 4% in local currencies. Brazil and Canada are the largest markets in this region with well developed livestock industries. Livestock sales grew 1% to $139 million due to sales of products for swine, poultry, and cattle. ZTS signed an agreement with a large cattle producer in Argentina to use *Clarifide* technology for genomic testing for better management of their herds. Companion Animal Sales fell 9% to $32 million.

In Asia pacific, revenue was $175 million, up 1%. Livestock sales rose 1% to $127 million. Strong sales of products for swine in Australia added to sales, offset by the impact of drought on southern Australia. Economic weakness in Japan also held back sales. ZTS launched the injectable antibiotic *Draxxin* in Japan during the quarter and registered the swine vaccine *Fostera PCV* for Porcine Circovirus Type 2. Companion Animal sales were flat at $48 million. In March, the company launched *Convenia*, an antibiotic for companion animals in China. *Convenia*, for use against bacterial skin infections, is a well established product sold in 50 countries.

Estimates

ZTS management provided 2013 revenue guidance in a range of $4.425 billion to $4.525 billion. Our 2013 revenue projection calls for continued single-digit U.S. revenue growth, assuming more normal weather patterns versus the 2012 drought. Some moderation in feed costs could occur as corn stocks were higher than expected and record corn planting is expected this year. European sales could benefit from stabilization in the euro versus the dollar, though some economic problems could persist. Growth in emerging markets is expected to continue. In all, we look for 2013 revenue of $4.50 billion, up 4% from $4.34 billion in 2012. We expect margin improvement due to acquisition integration and synergies from acquisitions in recent years. We forecast a modest increase in the gross margin due to operational efficiencies and gains from acquisition integration. Management anticipates a small decline in SG&A despite costs to operate as a standalone company. R&D could also decline modestly, as well. We incorporate a high level of interest expense resulting from the separation and a lower tax rate in our projection. Management provided an expected 2013 EPS guidance range of $1.36 to $1.42, excluding non-recurring items. Our 2013 EPS estimate is $1.40.

Financial

Pro-forma balance sheet figures reflect the transactions with Pfizer as part of the separation. Zoetis issued $3.64 billion in debt in order to transfer cash to Pfizer and retire $1 billion in existing Pfizer debt. Following these transactions, Zoetis had $3.64 billion in long-term debt at the end of March 2013 compared to $684 million in shareholders’ equity.

For 2012, operating cash flow declined to $454 million from $497 million in 2011 due to the seasonal inventory building for cattle products and higher inventory levels of other targeted products. Capital expenditures of $126 million in 2012 were relatively modest in relation to cash flow. Management indicated its intention to pay a quarterly dividend of $0.065 per share to holders of both Class A and Class B common stock, subject to the discretion of the Board of Directors. Subsequently, the Board of Directors declared a $0.065 per share dividend for the second quarter of 2013, payable to shareholders on June 6, 2013.

Figure 3. Zoetis Inc. Pro-forma Consolidated Statement of Income
(figures in millions except percentages)

	2014E	% Chg.	2013E	% Chg.	2012 (Pro-forma)	% Chg.	2011 (Pro-forma)	2011
Cattle	$1,700	4.6%	$1,625	1.1%	$1,608	(0.6%)	$1,617	$1,617
Swine	630	5.0%	600	1.7%	590	5.0%	562	562
Poultry	535	3.9%	515	2.8%	501	0.0%	501	501
Other (Fish and Sheep)	115	4.5%	110	2.8%	107	9.2%	98	98
Total Livestock	2,980	4.6%	2,850	1.6%	$2,806	1.0%	2,778	2,778
Dogs and Cats	1,525	5.2%	1,450	8.0%	1,343	4.4%	1,287	1,287
Horses	220	10.0%	200	7.0%	187	11.3%	168	168
Total Companion Animal	1,745	5.8%	1,650	7.8%	1,530	5.2%	1,455	1,455
Revenue	4,725	5.0%	4,500	3.8%	4,336	2.4%	4,233	4,233
Cost of Sales	1,635	3.8%	1,575	1.7%	1,549	(2.3%)	1,585	1,585
Gross Profit	3,090	5.6%	2,925	5.0%	2,787	5.2%	2,648	2,648
Sell., Gen'l. & Admin.	1,450	1.4%	1,430	(1.4%)	1,451	0.6%	1,443	1,443
Research & Develop.	410	5.1%	390	(2.3%)	399	(2.0%)	407	407
Amort. Of Intang.	20	0.0%	20	25.0%	16	(23.8%)	21	21
Total Operating Exp.	1,880	2.2%	1,840	(1.4%)	1,866	(0.3%)	1,871	1,871
Operating Income	1,210	11.5%	1,085	17.8%	921	18.5%	777	777
Interest Expense	(115)	0.0%	(115)	(5.7%)	(122)	0.0%	(122)	
Other Income	30	57.9%	19	(38.7%)	31	10.7%	28	(8)
Income before Taxes	1,125	13.8%	989	19.2%	830	21.5%	683	769
Income Taxes	326	13.8%	287	(16.1%)	342	48.7%	230	263
Minority Interest	0	- -	0	- -	5	- -	3	3
Net Income	$799	13.8%	$702	45.4%	$483	7.3%	$450	$503
Earnings Per Share	$1.60	13.8%	$1.40	45.4%	$0.97	7.3%	$0.90	
Avg. # Dil. Shs. Outstand'g	500	0.0%	500	0.0%	500	0.0%	500	
Gross Margin	65.40%		65.00%		64.28%		62.56%	62.56%
Sell., Gen'l. & Admin.	30.69%		31.78%		33.46%		34.09%	34.09%
Research & Develop.	8.68%		8.67%		9.20%		9.61%	9.61%
Operating Margin	25.61%		24.11%		21.24%		18.36%	18.36%
Tax Rate	29.00%		29.00%		41.20%		33.67%	34.20%
Sales by Region:								
United States	1,995	5.8%	1,885	6.1%	1,776	7.1%	1,659	1,659
Europe/Africa/Middle East	1,160	3.1%	1,125	2.6%	1,096	(4.2%)	1,144	1,144
Canada/Latin America	810	4.5%	775	0.8%	769	(2.4%)	788	788
Asia Pacific	760	6.3%	715	2.9%	695	8.3%	642	642
Total	$4,725	5.0%	$4,500	3.8%	$4,336	2.4%	$4,233	$4,233
Percentage of Revenue:								
United States	42.22%		41.89%		40.96%		39.19%	39.19%
Europe/Africa/Middle East	24.55%		25.00%		25.28%		27.03%	27.03%
Canada/Latin America	17.14%		17.22%		17.74%		18.62%	18.62%
Asia Pacific	16.08%		15.89%		16.03%		15.17%	15.17%

Note: Figures exclude non-recurring items
Source: Company reports and Hilliard Lyons' estimates

Outlook

As a global provider of animal health products, Zoetis has numerous potential avenues to sustain revenue and earnings growth. With the company's large direct sales force, established customer relationships could result in market share gains and could facilitate the adoption of new products.

Along the same lines, Zoetis spends sizeable amounts on R&D and has been responsible for a significant percentage of new products within its industry. Continued new product development and introduction can enhance the existing product line and provide additional medicines and vaccines to be marketed by ZTS's sales force. Finally, the company's worldwide marketing capabilities could make Zoetis an attractive partner for licensing of new products and technologies.

Emerging markets are a potential source of revenue growth as standards of living improve and the demand for animal protein grows. Similar factors can spur additional spending on companion animals. The Asia/Pacific region has been the fastest growing for Zoetis. Canada and Latin America have performed well, though currency has been negative.

We look for ZTS to pursue complementary acquisitions. The addition of acquired businesses from Wyeth (Fort Dodge Animal Health) and King Pharmaceuticals (King Animal Health) boosted growth in 2010 and 2011, respectively. Smaller tuck-in acquisitions could add products, technology, or an expanded sales presence.

Conclusion

There are no large, publicly traded animal health companies similar to Zoetis to use as a benchmark valuation for Zoetis. Other such businesses are generally part of multinational pharmaceutical firms, similar to the case of Pfizer's ownership of Zoetis. As a standalone business, we have noted certain attractive characteristics of Zoetis. Revenue is fairly reliable due to the needs of livestock producers and pet owners. In addition, research is generally faster and less expensive because clinical studies are less expensive than for human pharmaceuticals. The business is typically self-pay as opposed to third party reimbursement in health care. Finally, there tends to be less generic competition and more brand loyalty. From a financial standpoint, we feel gross margins of over 60% and operating margins of over 20% are relatively high though below that of drug companies.

We are raising our rating on Zoetis to Buy from Neutral. Zoetis shares were priced at $26 per share in the public offering, rose nearly 20% in the first day of trading, and increased in price from there. Recently, the share price has retreated to what we consider a more attractive level. We view Zoetis as a large capitalization growth stock with a strong market position and attractive growth prospects. As a proxy for valuing Zoetis, we looked at a group of companies deriving some or all of their business from the manufacture or distribution of animal care products. We have shown these in Figure 4. After reviewing the comparative valuations, the average P/E ratio is about 23 times. We feel Zoetis might receive a premium due to its size, global reach, and strong market position. With the ZTS shares currently trading at 22 times our 2013 EPS estimate, we feel the stock is attractive. Our price target is $36 per share. We arrive at our target by using our 2014 EPS estimate of $1.60 and assuming ZTS could at least maintain its current valuation.

Based on March 2013 financial data, we have elected to change our suitability rating to 3 from 2 due to the high amount of ZTS's debt relative to Shareholders' Equity, though we take some comfort in our 2013 estimate of operating income covering interest expense by approximately nine times. We also note that Zoetis has a limited trading history as a public company. We will review this rating as debt is reduced and investor familiarity with the stock improves.

Figure 4. Comparative Valuation of Selected Animal Health Companies

	Sym	FY	6/24/13 Price	Earnings Per Share 2011	2012	2013E	% Chg '11 - '12	% Chg '12 - '13E	P/E Ratio 2012	2013E	2012 Revenue (mil.)	Market Cap. (mil.)	Shares Out. (mil.)
Idexx Laboratories	IDXX	Dec.	$89.47	$2.75	$3.13	$3.44	13.8%	9.9%	28.6X	26.0X	$1,293	$4,892	54.7
MWI Veterinary Supply	MWIV	Sept.	$121.48	$3.41	$4.23	$4.87	24.0%	15.1%	28.7X	24.9X	$2,075	$1,554	12.8
Neogen Corp.*	NEOG	May	$54.37	$0.94	$1.13	$1.31	20.2%	15.9%	48.1X	41.5X	$184	$1,297	23.9
Petsmart*	PETM	Jan.	$67.23	$2.56	$3.55	$3.95	38.7%	11.3%	18.9X	17.0X	$6,758	$7,225	107.5
PetMed Express*	PETS	Mar.	$12.56	$0.80	$0.86	$0.87	7.5%	1.2%	14.6X	14.4X	$228	$251	20.0
Henry Schein	HSIC	Dec.	$94.07	$3.97	$4.43	$4.86	11.6%	9.7%	21.2X	19.4X	$8,940	$8,278	88.0
VCA Antech	WOOF	Dec.	$25.07	$1.36	$1.37	$1.54	0.7%	12.4%	18.3X	16.3X	$1,700	$2,201	87.8
Average							16.7%	10.8%	25.5X	22.8X			
Zoetis, Inc.	ZTS	Dec.	$30.38	$0.90	$0.97	$1.40	7.8%	44.3%	31.3X	21.7X	$4,336	$15,190	500.0

*Fiscal year ends in month of the following calendar year

Source: Baseline and Hilliard Lyons' Estimates

Risks and Considerations

Risks to our valuation include but are not limited to:

Restriction on use of animal medicines. Resistance to using anti-bacterials or other medicines in animals used for food could reduce demand and negatively impact revenue.

Conditions in the livestock industry. Unfavorable economics in the cattle, poultry, or swine markets could result in smaller herds and reduced demand for animal care products.

Weather extremes. Drought conditions can raise the cost of animal feed, leading to reductions in herd size.

Acquisition-related integration risks. Zoetis has augmented organic growth with acquisitions. Merging of different corporate cultures could make it difficult to achieve desired synergies.

Failure of new products. Zoetis spends a considerable amount on R&D to develop new products. Failure of products to achieve the desired result or reach the market could negatively affect revenue and earnings.

Economic activity. Rising standards of living, particularly in emerging markets, has increased the demand for animal protein. A weakening of the global economy could reduce this demand. Economic conditions can also affect the amounts consumers can spend on companion animals.

Operating as a separate entity. There will be additional expenses to operate as a standalone company. Pfizer plans to provide support initially, but Zoetis will ultimately be responsible for corporate functions.

High level of debt. Following the separation from Pfizer, Zoetis has $3.64 billion in debt compared to $684 million in equity, along with a significant amount of interest expense.

Prices of stocks mentioned: Pfizer (PFE - $27.71).

Additional information is available upon request.

Analyst Certification

I, Stephen A. O'Neil, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

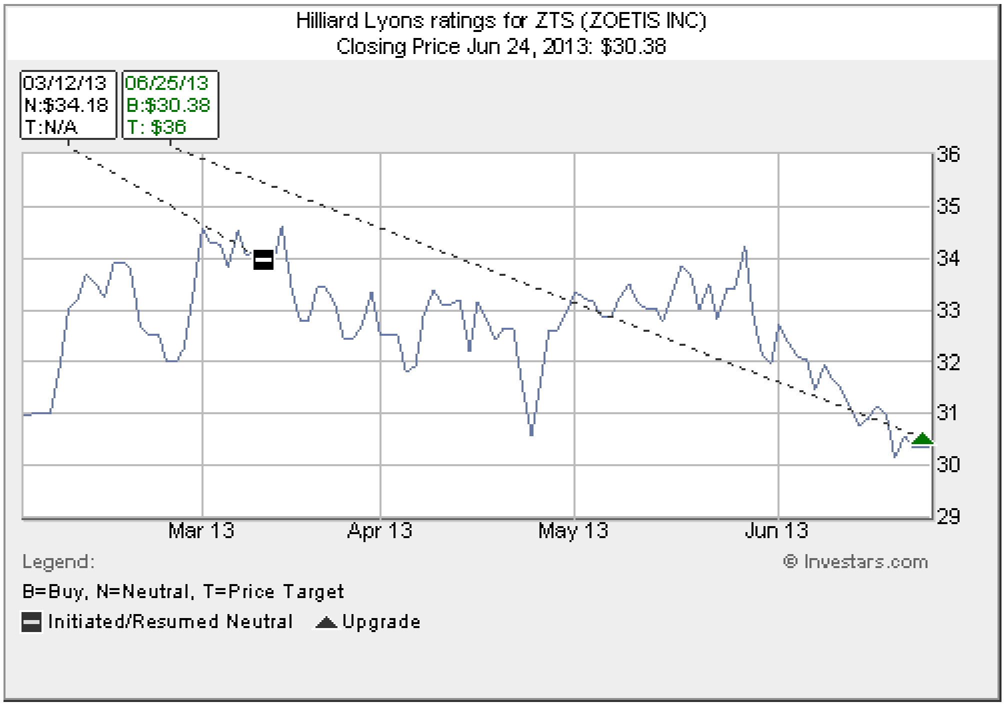
Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report or members of his household have a long position in the common stock of Pfizer, but may not engage in buying or selling contrary to the recommendation.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base



	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	49	36%	14%	86%
Hold/Neutral	83	60%	13%	87%
Sell	6	4%	0%	100%

As of 5 June 2013

Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

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