

Wednesday, March 13, 2013

Zoetis (Underperform)

(ZTS-NYSE)

We Believe the Bulls Are Too Aggressive

Flash:

With the restriction on research coverage of Zoetis from the IPO underwriters expiring, a number of firms launched coverage this morning bringing the total to seven buy ratings and six neutral ratings. We remain the only firm with an Underperform rating.

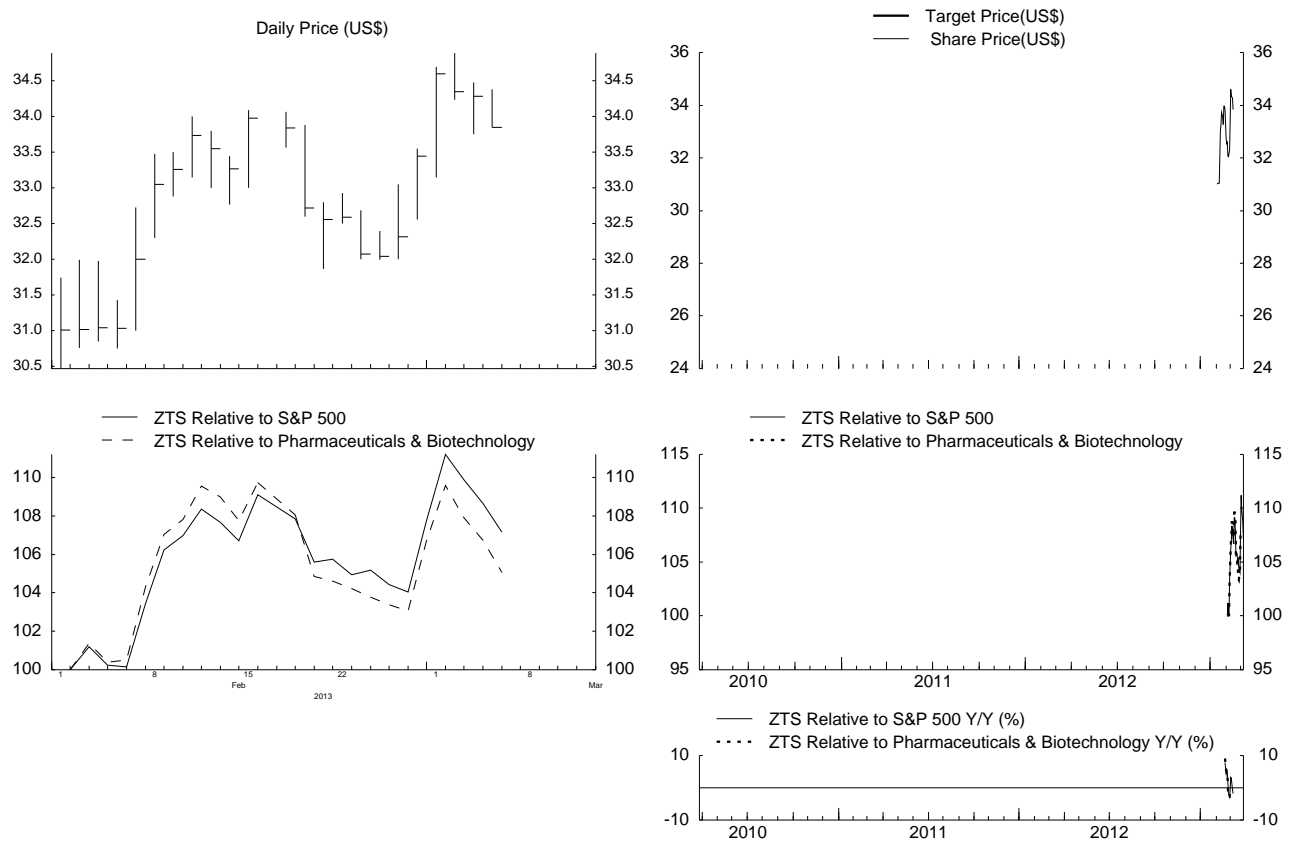
Our View:

- * We believe the bulls are being too aggressive. Overall, there is consensus that Zoetis is a unique healthcare growth story with therapeutic and geographically diversified revenues and strong fundamental growth drivers (i.e., growing global demand for animal protein and pet ownership, particularly in emerging markets). All seem to forecast top-line growth of 5%-7%, basically in line with the market. Moreover, there is consensus that the company will undoubtedly become more efficient and improve margins following its separation from Pfizer (PFE, \$27.94; Outperform). However, we believe that some expectations that the company can improve operating margins by at least 800 basis points by 2017 might be too aggressive and pre-mature. We forecast operating margins improving by 530 basis points from 2012 to 2017.
- * We see similar aggressive assumptions on valuation, such as P/E multiples of 25-28x despite 12%-15% expected EPS growth rates, and use of what we believe to be inadequate comparators: e.g. IDEXX Laboratories (IDXX, Not Rated) and Abaxis (ABAX, Not rated), which are primarily animal diagnostic and technology companies, and not medicines and vaccines companies like Zoetis. Finally, we note that the 7.5% discount rate assumed in the DCF models of some of the Bulls could also be too aggressive.
- * The other key difference vs. our forecasts is a lower-than-expected effective tax rate (most Bulls 29%, BMO 33%-34%) and higher terminal growth rate (Bulls ~3%, BMO 2.5%). Although we know that Zoetis has taken a number of steps to lower its tax rate, we are awaiting more details from the company regarding the expected rate going forward and pace of decline. However, lowering the tax rate in our forecasts to 30% in 2013 and 29% in 2014 and beyond produces a price target of \$30, roughly 12% below current levels. Moreover, increasing the terminal value growth rate from 2.5% to 3% produces a price target of \$32. Therefore, we believe that ZTS shares are at best fully valued, and may not reflect some of the recent risks, such as increased scrutiny of livestock antibiotics use in China.

Company:	Zoetis (ZTS)
Price/Rating/Target:	\$33.82/Underperform/\$28.00
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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.

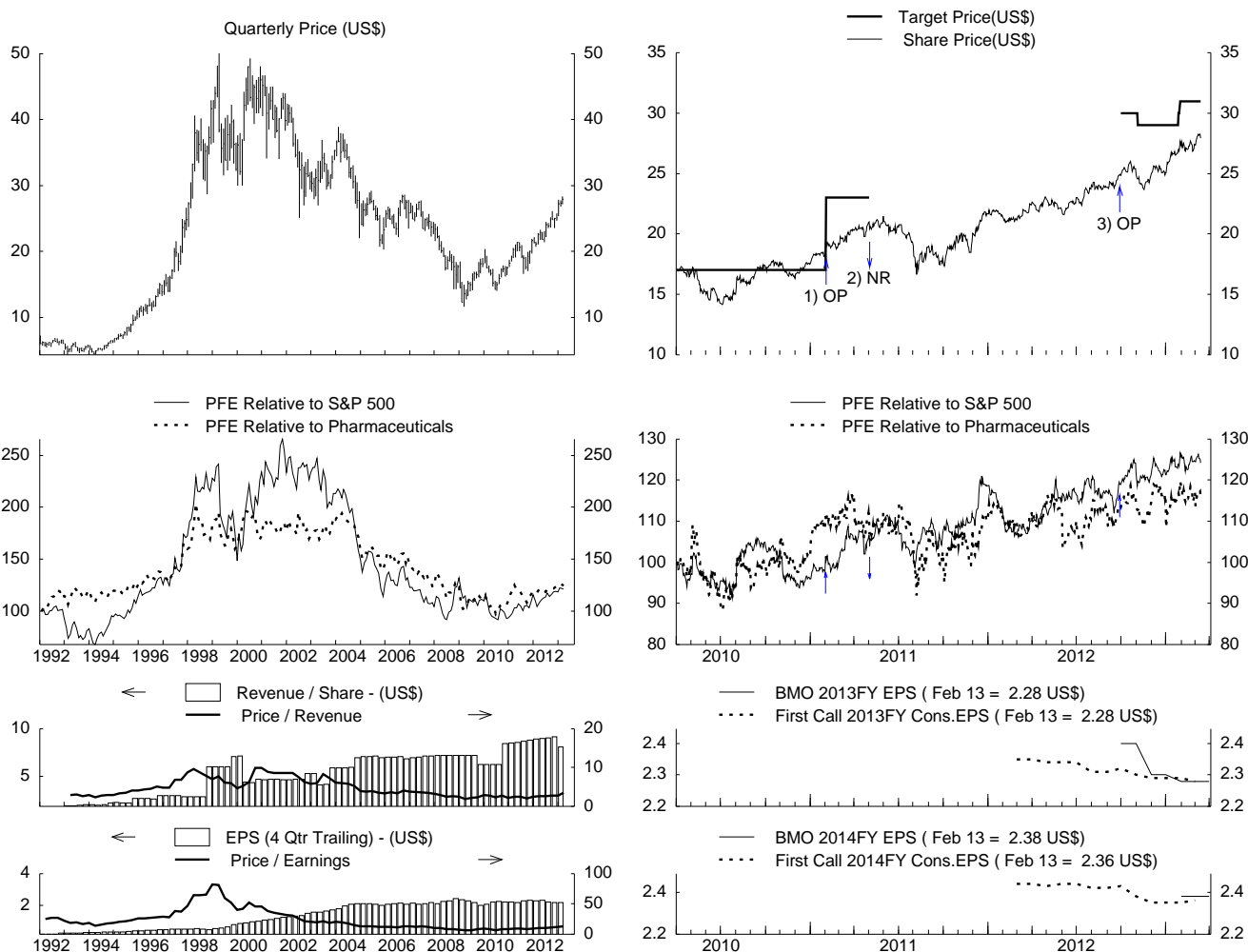
ZOETIS INC (ZTS)



ZTS - Rating as of 28-Jan-13 = NR

Last Daily Data Point: March 6, 2013

Pfizer Inc. (PFE)



FYE (Dec.)	EPS US\$	P/E Hi - Lo	DPS US\$	Yield% Hi - Lo	Payout %	BV US\$	P/B Hi - Lo	ROE %
1992	0.27	26.9 20.1	0.12	2.3 1.7	46	1.2	6.0 4.5	
1993	0.31	21.5 14.1	0.14	3.2 2.1	45	1.0	6.6 4.4	28
1994	0.35	18.9 12.6	0.16	3.5 2.4	45	1.1	5.8 3.9	33
1995	0.41	27.2 14.9	0.09	1.4 0.8	21	1.4	7.7 4.3	32
1996	0.50	30.4 19.4	0.20	2.1 1.3	40	1.8	8.5 5.4	31
1997	0.53	50.3 25.0	0.23	1.7 0.9	43	2.0	13.1 6.5	28
1998	0.51	84.3 45.5	0.29	1.3 0.7	58	2.3	>15 10.2	24
1999	0.82	61.0 38.5	0.36	1.1 0.7	44	2.3	>15 13.7	36
2000	1.02	48.3 29.4	0.44	1.5 0.9	43	2.6	>15 11.8	42
2001	1.27	37.8 26.8	0.52	1.5 1.1	41	2.9	>15 11.7	47
2002	1.53	28.7 16.4	0.60	2.4 1.4	39	3.2	13.6 7.8	50
2003	1.75	21.1 15.4	0.68	2.5 1.8	39	8.5	4.3 3.2	30
2004	2.12	18.3 10.4	0.76	3.5 2.0	36	9.1	4.3 2.4	24
2005	2.02	14.5 10.0	0.96	4.7 3.3	48	8.9	3.3 2.3	22
2006	2.08	13.8 9.7	1.16	5.7 4.1	56	10.0	2.9 2.0	22
2007	2.20	12.7 10.1	1.28	5.8 4.6	58	9.6	2.9 2.3	22
2008	2.43	10.1 5.9	1.28	9.0 5.2	53	8.5	2.9 1.7	27
2009	2.02	9.4 5.8	0.72	6.2 3.8	36	11.2	1.7 1.0	21
2010	2.22	9.2 6.3	0.80	5.7 3.9	36	11.0	1.9 1.3	20
2011	2.31	9.5 7.1	0.88	5.4 4.0	38	10.8	2.0 1.5	21
2012	2.19	11.9 9.0	0.96	4.9 3.7	44	11.1	2.4 1.8	20

Range*:

Current* 2.20 12.4 0.96 3.5 44 11.1 2.5 20

Growth(%):

5 Year:	0.0	-5.6	2.9
10 Year:	3.8	4.8	13.1
20 Year:	11.1	10.1	11.7

* Current EPS is the 4 Quarter Trailing to Q4/2012.

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

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

PFE - Rating as of 1-Apr-10 = Mkt

Date	Rating Change	Share Price
1 2-Feb-11	Mkt to OP	\$18.96
2 3-May-11	OP to NR	\$20.44
3 27-Sep-12	NR to OP	\$24.96

Last Price (March 12, 2013): \$27.94

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 PFE

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

Methodology and Risks to Our Price Target

Methodology: DCF: Free Cash Flow To Equity.

Risks: Uncertainty of Phase 3 Pipeline.

Distribution of Ratings (December 31, 2012)

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
Buy	Outperform	37.0%	17.7%	52.9%	38.5%	50.5%	54.0%
Hold	Market Perform	60.7%	9.6%	47.1%	57.3%	48.4%	40.6%
Sell	Underperform	2.4%	0.0%	0.0%	4.2%	1.0%	5.4%

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

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OP = Outperform - Forecast to outperform the market;

Mkt = Market Perform - Forecast to perform roughly in line with the market;

Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;

NR = No rating at this time;

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