

Zoetis, Inc.

(ZTS - \$31.73)

January 21, 2014

Company Update | **Note**

Medical Devices & Supplies

Strong Buy
\$41.00

Trading Data:

Last Price (1/17/2014)	\$31.73
52-Week High (3/14/2013)	\$35.42
52-Week Low (8/28/2013)	\$28.81
Market Cap. (MM)	\$15,865
Shares Out. (MM)	500.007
3 Month Avg. Daily Vol. (MM)	3.311

Earnings Estimates: (\$ per share)

(Dec)	Q1	Q2	Q3	Q4	FY
FY15E	0.44	0.45	0.43	0.43	1.75
FY14E	0.39	0.41	0.39	0.38	1.57
FY13E	0.36A	0.36A	0.34A	0.34	1.40
FY12A	0.30	0.35	0.30	0.12	1.08

Valuation:

Multiple	FY14	FY15	FY15 @ PT
P/E	20.2	18.1	23.4
EV / EBITDA	13.3	11.8	14.9
EV / Revs.	3.9	3.5	4.4

Source: CL King & Associates estimates

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See required disclosures at the end of report.

Apoquel: Our Observations at NAVC Suggest Potential for this New Drug is Significant

- Our observations at NAVC increase our confidence in Apoquel's revenue potential. Apoquel is a novel treatment for "itchy" dogs that the FDA approved in May. Previously published clinical studies have shown Apoquel has equal efficacy and a meaningfully better safety profile compared to existing therapies.
- Expert commentary about Apoquel was very positive, and attendees at NAVC had a high level of interest in the product. Zoetis appears to be placing significant market resources behind the product.
- Several of the clinicians with experience using the drug in clinical trials and/or as part of the Early Experience Program described Apoquel as "revolutionary," "a breakthrough," and "a game-changer."
- We believe Apoquel's revenue potential is significant, and our confidence in our projection of 6% compound annual revenue growth for Zoetis over the next five years has increased.
- We do not believe investors fully appreciate the revenue potential of Apoquel. We reiterate our Strong Buy rating.

Observations at NAVC increase our confidence in Apoquel's potential:

Zoetis' new drug Apoquel for "itchy" dogs was prominently displayed at the North American Veterinary Association (NAVC) annual meeting, which began on Saturday. Based on our observations we are more confident that Apoquel should be a significant driver of Zoetis' revenues over the next four or five years. In turn, this increases our conviction in our projection that Zoetis' revenue should have compound annual revenue growth of about 6% over the next five years. If Apoquel achieves the high end of our expectations we believe there is some probability it could help fuel a slightly faster growth rate. We believe investors do not fully appreciate the revenue potential of Apoquel.

Apoquel is a novel drug for treatment of "itchy" dogs that the FDA approved in May 2013:

The FDA approved Apoquel in May 2013 for treatment of pruritus (itching) associated with allergic dermatitis and atopic dermatitis in dogs at least 12 months of age. Zoetis conducted a controlled launch of Apoquel during the last one or two quarters; under this Early Experience Program Zoetis limited its marketing of Apoquel to veterinary dermatologists and a small number of general veterinary practitioners. Zoetis is just now initiating its marketing efforts to general veterinary practitioners. Very

briefly, Apoquel is a novel targeted approach to treating pruritus. Specifically, it is a Janus kinase inhibitor that specifically targets Janus kinase 1 (JAK1) dependent cytokines; these cytokines are involved in promoting inflammation and itching. At the same time, Apoquel has minimal activity against JAK2 dependent cytokines, which helps to minimize unwanted, serious side effects.

Expert commentary was very positive and attendees had a high level of interest in Apoquel: Based on our observations at NAVC, including attendance at a handful of clinical presentations focused on dermatology, we believe the veterinary dermatologists using Apoquel during the limited launch have had very favorable experiences with the drug. In addition, the veterinarians attending NAVC appeared to have a high level of interest in the product. Interestingly, Zoetis' exhibit booth appeared to be a little larger than in past years, and close to half of the space within the booth was used to feature Apoquel. We view this as good evidence that Zoetis plans to invest significant marketing and educational resources to build awareness and utilization of Apoquel. Some of the clinicians with experience using the drug in clinical trials and/or as part of the "Early Experience Program" described Apoquel as "revolutionary," "a breakthrough" and "a game-changer."

There is a very substantial need for therapies with an improved safety profile: As noted above, Apoquel is approved for treatment of pruritus (itching) associated with allergic dermatitis and atopic dermatitis. Current treatments for pruritic dogs are largely limited to corticosteroids and Novartis' (NVS^^: NR) Atopica (cyclosporine). While the efficacy of these therapies is generally very good to excellent in most dogs, both have significant side effects that eventually can be detrimental to the health of the dog. As a result, there is a very substantial need for a therapy that provides an equal level of efficacy combined with improved safety.

Apoquel has equal efficacy and significantly better safety than existing therapies: Clinical studies indicate Apoquel has a much more favorable safety profile than the products currently used to control pruritus in dogs and a comparable level of efficacy. In addition, the time to onset of activity for Apoquel is about four hours, which is equivalent to corticosteroids and considerably faster than the two- to three-week onset of activity for Atopica.

Based on our observations at NAVC and conclusions from the clinical studies, we believe over time veterinarians will use Apoquel as a substitute for corticosteroids in many patient cases. With regard to more complex patients that are being successfully treated with Atopica, we believe veterinarians will be reluctant to change therapies. However, for dogs that do not respond to Atopica we believe veterinarians will utilize Apoquel as a substitute. Similarly, for new complex cases that require more treatment with more than just corticosteroids we believe over time there is a good probability veterinarians will increasingly prescribe Apoquel rather than Atopica.

We believe the peak revenue potential of Apoquel is material for Zoetis: Estimating the market size and peak revenue potential for Apoquel is challenging, because the cases in which Apoquel may be used ranges from relatively simple cases that may require only a few days of treatment to patients that will require treatment on essentially a year-round or perpetual basis. Nevertheless, the number of itchy dogs in the U.S. and in developed international markets is very large, and we believe the market opportunity for Apoquel is significant.

At present, we estimate the global peak revenue potential for Apoquel should be in a range of \$200MM to \$400MM annually. However, we believe there is a higher probability Apoquel's peak revenues fall into the upper half of this range, rather than the lower half. We should note we plan to conduct additional research to more accurately refine our estimate of the drug's peak revenues. However, we show our current rough assumptions by which we arrive at our estimate of the range of peak revenues for Zoetis in Table 1 below. We believe our "mid-case" and our "high-case" assumptions shown in Table 1 are the best to use for calculating the range of potential peak revenues for Apoquel. Our "low-case" assumptions are excessively conservative, in our view.

Table 1: Rough estimates of Apoquel's peak revenues

Line					
No.	Math	Item	Amount		
1.		Total number of dogs in the U.S.	83,000,000		
2.		Percent with atopic dermatitis	11.0%		
3.	L.1 * L.2	Number with atopic dermatitis	9,130,000		
Line					
No.	Math	Item	Low Estimate	Mid Estimate	High Estimate
4.		Percentage w atopic dermatitis treated by a veterinarian	20%	25%	30%
5.	L.3 * L.4	Number treated by a veterinarian	1,826,000	2,282,500	2,739,000
6.		Share of dogs treated by Apoquel at peak	20%	25%	30%
7.	L. 5 * L. 6	Number of dogs treated by Apoquel at peak	365,200	570,625	821,700
8.		Average Apoquel revenue per case	\$150	\$175	\$250
9.	L. 7 * L. 8	Total Apoquel revenues - U.S.	\$54,780,000	\$99,859,375	\$205,425,000
10.	= L. 9	Total Apoquel revenues - International	\$54,780,000	\$99,859,375	\$205,425,000
11.	L.9 + L.10	Total Apoquel revenues - Global	\$109,560,000	\$199,718,750	\$410,850,000

Source: CL King & Associates estimates

An alternative approach to estimating revenue potential: As an alternative, we note that we intuitively believe Apoquel has the potential to generate revenues comparable to Zoetis' largest products, given that Apoquel targets a large market and satisfies a significant market need of delivering significantly improved safety with equal efficacy compared to existing therapies for pruritus on the market. Based on Zoetis' disclosures in its SEC filings, we estimate the company's top selling product is its Ceftriaxone line with approximately \$300MM in revenues. Also, the disclosures suggest to us that both Zoetis' Revolution and Draxxin products have revenues of just under \$300MM.

We anticipate it will take five years or more to achieve peak revenues: We emphasize that we believe it will take at least five years for Apoquel to achieve our peak revenue projections. We believe it will take time for veterinarians as a group to be educated about the benefits of the drug and to begin using it. In addition, we anticipate the expansion of Zoetis' sales and marketing efforts for Apoquel to the international markets will take time. We should note that Zoetis has endeavored to price Apoquel competitively. Based on Zoetis' sales literature available at NAVC, we estimate the company is pricing Apoquel at about \$0.80 per pill. The Apoquel label indicates dogs should be treated with two pills per day for the first two weeks of therapy and with one pill per day thereafter, as

long as treatment is still necessary. This pricing structure is a premium to corticosteroids, which are relatively inexpensive. However, Apoquel is priced slightly below Atopica.

Some risks to our outlook: We should note that our primary concern is that as with the case of most drugs, there is a risk that unexpected side effects could become evident after large numbers of patients are treated over a long period. Zoetis already has clinical experience and data for a number of dogs treated for as long as four years, helping to lessen this risk.

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	2015E
Stock price	\$31.73	\$31.73	\$31.73	\$31.73
Revenues (in 1,000's)	\$4,336,000	\$4,524,650	\$4,831,626	\$5,134,203
EBITDA (in 1,000's)	\$1,105,000	\$1,299,832	\$1,397,854	\$1,523,271
EPS - GAAP	\$1.01	\$1.37	\$1.48	\$1.66
EPS adj to add back amortization exp.	\$1.08	\$1.40	\$1.57	\$1.75
P / E ratio - based on adj. EPS	29.4 x	22.7 x	20.2 x	18.2 x
EV / EBITDA ratio	17.2 x	14.7 x	13.3 x	11.8 x
EV / Revenue ratio	4.4 x	4.2 x	3.9 x	3.5 x
ROA	9.2%	11.8%	13.4%	14.9%
ROE	22.2%	63.5%	55.7%	42.1%
Enterprise value computation:				
Equity market value (in 1,000's)	\$15,865,000	\$15,951,344	\$16,111,457	\$16,273,176
Total debt (in 1,000's)	\$3,640,000	\$3,352,000	\$2,552,000	\$1,952,000
Cash (in 1,000's)	\$484,000	\$194,381	\$52,248	\$184,146
Enterprise value (in 1,000's)	\$19,021,000	\$19,108,963	\$18,611,209	\$18,041,031

Source: CL King & Associates estimates

Risks: *There are a number of potential risks that could have a negative effect on Zoetis' business and its stock. To begin, there is a risk 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. Also, 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 could negatively affect Zoetis' production animal business. For example, drought can result in higher grain and feed prices and reduce available grazing pastures, either one of which 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 successful in improving margins as much as we expect. Also, the company may not be as effective as we project in managing its operations and expenses during its process of fully separating from Pfizer (PFE: NR).*

Previous research update – 11/6/13

DISCLOSURES:

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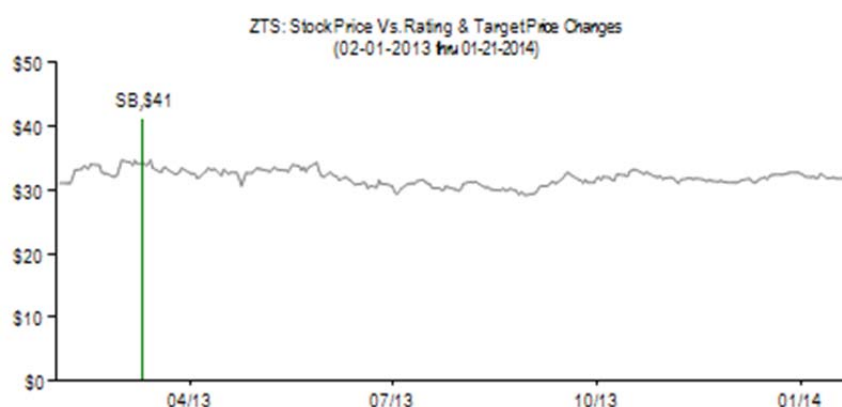
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** Designates companies in which CL King & Associates currently maintains a market.

^^ The covering analyst owns shares of the company.

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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.	15.60%	0.00%	1.83%
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.	38.53%	1.83%	0.92%
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.	43.12%	1.83%	2.75%
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.	0.92%	0.00%	0.00%

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