HILLIARD LYONS

**Animal Health**
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

**Key Metrics**

| | | |
|---|---|---|
| ZTS - NYSE (as of 08/08/17) | | $60.00 |
| Price Target | | $76.00 |
| 52-Week Range | | $46.86 - $63.85 |
| Shares Outstanding (mm) | | 494.0 |
| Market Cap. ($mm) | | $29,448 |
| 1-Mo. Average Daily Volume (000's) | | 633,436 |
| Institutional Ownership | | 95% |
| Debt / Total Capital | | 57.3% |
| ROE (TTM) | | 56.6% |
| Book Value / Share | | $3.53 |
| Price / Book Value | | 17.0x |
| Indicated Dividend / Yield | $0.42 | 0.7% |
| TTM Operating Margin | | 30.5% |

**Non-GAAP EPS FYE 12/31**

| | 2016A | Prior 2017E | Curr. 2017E | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|
| 1Q | $0.48 | | $0.53A | $0.62 | $0.60 |
| 2Q | $0.49 | | $0.53A | $0.65 | $0.64 |
| 3Q | $0.52 | $0.64 | $0.66 | $0.70 | $0.70 |
| 4Q | $0.47 | $0.59 | $0.60 | $0.65 | $0.65 |
| Year | $1.96 | $2.33 | $2.31 | $2.61 | $2.59 |
| P/E | 30.7x | | 25.9x | | 23.2x |

*Figures may not add up due to rounding*

**Revenue ($b)**

| | 2016A | Prior 2017E | Curr. 2017E | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|
| 1Q | $1.16 | | $1.23A | $1.31 | $1.30 |
| 2Q | $1.21 | | $1.27A | $1.37 | $1.36 |
| 3Q | $1.24 | $1.33 | $1.33 | $1.40 | $1.40 |
| 4Q | $1.28 | $1.38 | $1.36 | $1.45 | $1.43 |
| Year | $4.89 | $5.22 | $5.19 | $5.54 | $5.49 |

***Company Description** – Based in Parsippany, New Jersey, Zoetis develops, manufactures, and markets pharmaceuticals and biologicals for both livestock and companion animals. The company also offers diagnostic products, genomic services, and other services to their customers, which primarily include livestock farmers, veterinarians, and pet owners. Most of the company's products aid in the healthcare of cats, dogs, equine, swine, beef and dairy cattle, sheep, poultry, and fish.*

# Zoetis Inc.

ZTS – NYSE – Buy – 2

## Solid but not Superb Quarter; Prospects Remain Bright

- **2Q17 Results:** Zoetis reported revenues of $1.27 billion, growth of 5% from the same period a year ago. This was even with the Street consensus but fell just shy of our estimate of $1.29 billion. Non-GAAP EPS also matched the Street consensus of $0.53 but fell short of our estimate of $0.57.
- **Positive Highlights:** The cattle segment exceeded our estimate and continues to recover nicely even in the face of dairy market softness and regulatory headwinds. The poultry business posted its first year-over-year growth number since 4Q14, providing another beat relative to our estimates.
- **Negative Highlights:** The GAAP gross margin registered at 65.3% versus our estimate of 66.9% and the Street consensus of 66.1%. The swine, fish, and companion animal segments all underperformed our assumptions. Additionally, higher than expected SG&A expenses led to core operating expenses above our estimate.
- **Outlook and Estimates:** The long-term story remains positive in our view, and we encourage investors to have confidence in management's ability to prevail through headwinds in swine and ignore the short-term volatility of the gross margin. We decreased our FY17 revenue estimate to $5.19 billion from $5.22 billion and decreased our FY17 non-GAAP EPS estimate to $2.31 from $2.33. We decreased our FY18 revenue estimate to $5.49 billion from $5.54 billion and decreased our FY18 non-GAAP EPS estimate to $2.59 from $2.61.
- **Valuation:** Zoetis closed yesterday at 29.4X trailing operating EPS and 24.0X our next twelve months operating EPS estimate. This forward multiple is well below its three year average of ~26X. We are maintaining our Buy rating but lowering our price target to $76 from $77. See page 4 for price target derivation.

**Note Important Disclosures on pages 7 and 8**
**Note Analyst Certification on page 7**

## ADDITIONAL COMMENTARY

| *Revenues in millions* | 2Q17 Revenue | Y/Y Growth | Quick Comment |
|---|---|---|---|
| Cattle | 382 | 4.4% | Strength in US and Brazil; positive signs in other mkts |
| Swine | 148 | -1.3% | Strength in China offset by tough competition in US |
| Poultry | 122 | 3.4% | MFAs performing well in face of RWA push by producers |
| Fish | 19 | -13.6% | Pricing discussions hurt this quarter but are resolved |
| Other | 18 | 5.9% | |
| **Livestock Total** | **689** | **2.4%** | Balanced between domestic and international growth |
| **Companion Animal** | **568** | **8.6%** | Dermatology portfolio strength |
| Contract Mfg. | 12 | 0% | |
| **Total Revenue** | **1,269** | **5.0%** | |

*Source: Company Reports*

### *Performance Review*

- Revenue growth of 5% faced a 1% headwind from currency exchange rates and 1% headwind from product rationalization. Management stated this is the last quarter in which the product rationalization will have a material impact. Most of the revenue growth was driven by the companion animal dermatology portfolio, with some additional contribution from older products.
- International growth was solid at 5%, with a 2% headwind from currency. Australian revenues were flat excluding currency but remains strong on a year-to-date basis. Brazilian operational growth of 8% remained positive in both livestock and companion animal (CA) and also benefitted from a strong currency tailwind. Solid 5% growth in Canada due to new CA products was more than offset by currency headwinds. Chinese revenues were up 14% on a constant currency basis, led by both swine and CA growth. Zoetis continues to perform well in Japan, with 17% operational growth. U.S. revenue growth of 5% was led by new CA products. Livestock growth of 3% was driven by cattle and poultry.
- Export demand for U.S. beef has been increasing due to lower average retail prices. U.S. cattle revenue growth occurred despite the headwind of mild weather (healthier animals) and the Veterinary Feed Directive (VFD). Strength in Brazil continued despite significant political uncertainty and bad publicity (such as food adulteration) for the industry. Other key international markets were stable or positive.
- Swine strength in China was not quite enough to overcome domestic weakness. Despite having improved the portfolio, management stated progress is coming slower than expected in regaining market share. The domestic swine business was also impacted by the VFD. Management noted new products in 2018 should boost the segment.
- Poultry growth came in spite of the VFD. Zoetis has multiple medicated feed additives (MFAs) that are not critical to humans and therefore give producers an option with more retailers and consumers demanding poultry raised without antibiotics (RWA). The movement also bolsters vaccine usage.
- The fish miss relative to our estimates was a bit alarming initially, but management noted pricing discussions slowed uptake in Chilean salmon markets. This has been resolved and management noted strength thus far in this quarter. Management reiterated expectations of double-digit growth for the segment but stated they don't view the $125 million in annual sales as achievable for this year. They remain confident in the aquaculture market prospects long-term.
- The CA segment continues to be dominated by the rapid uptake of the dermatology portfolio (Apoquel and Cytopoint). The two products crossed the $100 million mark ($102 million to be exact) in a single quarter for the first time. This is a somewhat seasonal product set but reinforces our belief the

dermatology portfolio will pierce the bottom end of management's intermediate-term goals of $400-$500 million as early as next year. Management stated this quarter showed yet again more dermatology cases are treated with one of these options (55% versus 52% in 1Q17). Simparica sales declined $9 million sequentially due to inventory stocking last quarter but management still feels confident in the product. Management also noted competitive pressure hurt the company's pain treatment, Rimadyl. Continued generic pressure was amplified by Aratana/ Elanco's Galliprant.

- The gross margin disappointed this quarter, and management narrowed guidance to the bottom end of the range. While it still hurts full year results, we are not very discouraged by the number, as management is confident they can still hit the range is reassuring for significant expansion in the next couple quarters. Additionally, our estimates were already at the bottom end of the range.
- Core operating expenses of $422 million were above our estimate ($415 million) due to SG&A expenses. SG&A was still down 2%, as declines in the business were slightly offset by increased DTC advertising for new CA products. R&D expenses were in line with our estimate at $86 million. After factoring in the above, the GAAP core operating margin was 32.1% versus our estimate of 34.6%. The non-GAAP core operating margin was 32.5% versus our estimate of 35.6%.
- Non-core operating expenses were $62 million versus our expectation of $73 million. The GAAP tax rate was noticeably lower than our estimate, while the non-GAAP tax rate was similar to our estimate. GAAP EPS of $0.50 was lower than our estimate of $0.52. Non-GAAP EPS of $0.53 was in line with the Street consensus but below our estimate of $0.57.

### *Balance Sheet and Cash Flow Review*

- Zoetis has generated $299 million in cash from operations year-to-date, a 59% increase year-over-year. The company has invested about $93 million in property and equipment this fiscal year and will have roughly $85 million in acquisitions in 3Q17 due to the Nexvet acquisition. Zoetis repurchased $125 million in shares in each of the first two quarters this year and paid just over $50 million in dividends in each quarter.
- Zoetis experienced a mild improvement in leverage ratios sequentially. Long-term debt now stands at 47.7% of total capital. Total debt / Equity is 3.5X. Despite fairly high leverage ratios, we remain comfortable with Zoetis' balance sheet due to the stability of the business and strong liquidity; the current ratio is 2.0X. EBITDA/ net interest was 10.9X in 2Q17 and FCF / net interest was 3.1X. We consider the dividend and our projected dividend increases to be well covered.

### *Guidance Update*

| | Previous Guidance | Updated Guidance |
|---|---|---|
| Revenue | 5,100 - 5,225 | 5,150 - 5,250 |
| Gross Margin | 67 - 68% | ~67% |
| SG&A | 1,265 - 1,325 | 1,285 - 1,325 |
| R&D | 360 - 380 | 365 - 385 |
| Other Expenses | ~160 | ~160 |
| Tax Rate | ~30% | ~29% |
| EPS | 2.26 - 2.36 | 2.30 - 2.37 |
| GAAP EPS* | 2.08 - 2.20 | 2.12 - 2.21 |

**All other items are on a non-GAAP basis; all figures in millions except per share data*

*Source: Company Reports*

## ESTIMATES UPDATE & OUTLOOK

From a top line perspective, the biggest change came from the swine category. Management had already hinted growth in China would likely slow in the back half of the year, but we are disappointed with progress on the domestic front in that category. We also lowered estimates for the CA segment. We remain confident in the dermatology story and actually increased our estimates for those products, but slightly tapered expectations for Simparica and remain cautious regarding ongoing Rimadyl pressures. Although we lowered aquaculture estimates, we remain confident in the story and FY18 estimates are down just marginally. On a positive note, we tweaked poultry estimates higher.

Despite the noteworthy gross margin miss, we only lowered the 2017 total by ~20 basis points and actually increased the 2018 estimate by ~10 basis points. We remain confident in management's expectations for the category and see this quarter as more of a timing issue. We admit it could be a choppy path to the 2020 goal (~200 basis point expansion from FY16) but this picture will take time to come into clearer focus. We lowered SG&A expense estimates but think investors should expect something toward the top end of guidance as management sees good returns on DTC advertising for new CA products and may be tempted to continue the campaign. We also increased R&D expense estimates to incorporate the Nexvet acquisition. As a reminder to investors, Nexvet will not contribute to revenue in the near term as the company is still in pipeline development for pain therapeutics.

After making modest tweaks to estimates for non-core operating expenses and tax rates, our FY17 non-GAAP EPS estimate is now $2.31 versus $2.33 previously. Our FY17 revenue estimate is $5.19 billion versus $5.22 billion previously. For FY18, we lowered revenue expectations to $5.49 billion from $5.54 billion and non-GAAP EPS to $2.59 from $2.61. Despite the slightly lower estimates, we are confident in the company's prospects and believe the stock is undervalued. We encourage investors to have confidence in management's ability to prevail through headwinds in swine and ignore the short-term volatility of the gross margin.

## VALUATION & SUITABILITY

Zoetis closed yesterday at 29.4X trailing operating EPS and 24.0X our next twelve months operating EPS estimate. To determine our price target, we took the average forward P/E seen since the efficiency initiative was announced (~26.7X) and incorporate at a DCF model to recognize impressive cash flow generation. Applying the 26.7X multiple to our 2H18 / 1H19 non-GAAP EPS estimate, we derive a $73 price target. Using a WACC of 9.3% and a two-stage growth model for free cash flow to equity, we calculate a $79 price target. We use the two-stage growth model due to confidence in the intermediate outlook for the company. However, we think it would be too aggressive to use our 7% growth rate (used for five years beyond our FY19 estimates) into perpetuity. Thus, our second stage growth rate assumption is a much more conservative 3%. Taking the average of these two valuation methodologies, we derive a $76 price target. We note this is down from $77 previously, as each valuation method resulted in a $1 lower price target.

Zoetis is well diversified in terms of products, customer base, and geographies. Their industry has an attractive secular growth profile and the CA segment is recession-resistant, in our view. However, the company's livestock customer base is subjected to commodity cycles. Further, Zoetis has a limited history as a publicly traded company and is fairly levered. Finally, we view the company's status as a growth stock as another risk to consider. Given these factors, our suitability rating is a 2.

## Risks & Considerations

- **Dependence on livestock industry** – Zoetis derives a significant amount of revenue from customers in or associated with the agricultural industry, which is subject to many factors beyond their control, such as weather or disease outbreaks.
- **Changes in consumer attitudes –** The companion animal business is dependent on consumers continuing to view their pets as a member of the family and treating them accordingly. A change in this attitude could halt the humanization of pets and harm Zoetis' outlook.
- **Competition –** The animal health business is highly competitive and attracts significant capital and new competitors. Innovative new products or solutions from competitors could displace Zoetis products.
- **Integration of acquisitions** – Zoetis has been fairly acquisitive throughout its history, and we anticipate that to continue. Failure to successfully integrate acquisitions could lead to financial results below expectations.
- **Failure of R&D and/or new products** – Zoetis also internally develops new products and product lines. Failure to successfully develop and sell new products could harm profitability.
- **Legal** – Product lawsuits are common in the health care sector. An unfavorable court decision could hamper the ability to market a product, whether a current patent under Zoetis is successfully challenged or Zoetis is determined to have infringed upon the patent of a competitor.
- **Regulatory** – Most Zoetis products must go through various regulatory agencies for approval. Further, the companion animal market could undergo a significant shift if any new regulations are introduced regarding veterinary prescription practices. On the other side of the business, the livestock industry is also subjected to significant regulatory requirements and oversight. These situations create uncertainty for both Zoetis and its customers.
- **Emerging markets exposure –** Zoetis derives a significant portion of its revenues (~22% in 2016) from emerging markets. These markets tend to be riskier due to political, economic, and/or currency instability.

| **ZOETIS INC.** | | | | | | | | | | **ZTS: BUY** |
|---|---|---|---|---|---|---|---|---|---|---|
| *In millions* | **2014** | **2015** | **2016** | **1Q17 A** | **2Q17 A** | **3Q17 E** | **4Q17 E** | **2017 E** | **2018 E** | **2019 E** |
| *Fiscal Period End** | **12/31/2014** | **12/31/2015** | **12/31/2016** | **4/2/2017** | **7/2/2017** | **10/1/2017** | **12/31/2017** | **12/31/2017** | **12/31/2018** | **12/31/2019** |
| **Income Statement** | | | | | | | | | | |
| Livestock | 3,103 | 2,958 | 2,881 | 703 | 689 | 764 | 826 | 2,982 | 3,148 | 3,333 |
| Companion Animal | 1,632 | 1,756 | 1,956 | 517 | 568 | 546 | 528 | 2,159 | 2,296 | 2,436 |
| Other | 50 | 51 | 51 | 11 | 12 | 16 | 10 | 49 | 50 | 51 |
| **Total Revenue** | **4,785** | **4,765** | **4,888** | **1,231** | **1,269** | **1,326** | **1,364** | **5,190** | **5,494** | **5,820** |
| **Gross Profit** | **3,068** | **3,027** | **3,222** | **788** | **829** | **921** | **905** | **3,443** | **3,704** | **3,938** |
| *Gross Margin %* | *64.1%* | *63.5%* | *65.9%* | *64.0%* | *65.3%* | *69.5%* | *66.4%* | *66.3%* | *67.4%* | *67.7%* |
| SG&A | 1,643 | 1,532 | 1,364 | 309 | 336 | 335 | 350 | 1,330 | 1,366 | 1,427 |
| R&D | 396 | 364 | 376 | 90 | 86 | 90 | 109 | 375 | 392 | 408 |
| **Core Operating Income** | **1,029** | **1,131** | **1,482** | **389** | **407** | **496** | **446** | **1,738** | **1,946** | **2,103** |
| *Core Operating Margin %* | *21.5%* | *23.7%* | *30.3%* | *31.6%* | *32.1%* | *37.4%* | *32.7%* | *33.5%* | *35.4%* | *36.1%* |
| Non-core Expenses** | 209 | 586 | 254 | 52 | 62 | 64 | 62 | 240 | 258 | 255 |
| **GAAP Pretax Income** | **820** | **545** | **1,228** | **337** | **345** | **432** | **384** | **1,498** | **1,688** | **1,848** |
| *GAAP Pretax Margin %* | *17.1%* | *11.4%* | *25.1%* | *27.4%* | *27.2%* | *32.6%* | *28.1%* | *28.9%* | *30.7%* | *31.8%* |
| *Effective Tax Rate* | *28.4%* | *37.8%* | *33.3%* | *29.1%* | *28.4%* | *29.5%* | *29.0%* | *29.0%* | *29.8%* | *29.6%* |
| **GAAP Net Income*** | **583** | **339** | **821** | **238** | **247** | **305** | **272** | **1,062** | **1,184** | **1,300** |
| Non-GAAP Adjustments | 207 | 550 | 154 | 23 | 14 | 21 | 21 | 79 | 82 | 74 |
| **Non-GAAP Net Income** | **790** | **889** | **975** | **261** | **261** | **326** | **293** | **1,141** | **1,266** | **1,374** |
| Diluted Shares O/S | 502.0 | 502.0 | 498.2 | 495.3 | 494.0 | 492.7 | 491.5 | 493.4 | 488.6 | 484.5 |
| **GAAP Diluted EPS** | **$ 1.16** | **$ 0.68** | **$ 1.65** | **$ 0.48** | **$ 0.50** | **$ 0.62** | **$ 0.55** | **$ 2.15** | **$ 2.42** | **$ 2.68** |
| **Non-GAAP Diluted EPS** | **$ 1.57** | **$ 1.77** | **$ 1.96** | **$ 0.53** | **$ 0.53** | **$ 0.66** | **$ 0.60** | **$ 2.31** | **$ 2.59** | **$ 2.84** |
| **Dividends per share** | **$ 0.288** | **$ 0.332** | **$ 0.380** | **$ 0.105** | **$ 0.105** | **$ 0.105** | **$ 0.105** | **$ 0.420** | **$ 0.480** | **$ 0.560** |
| **Balance Sheet** | | | | | | | | | | |
| Cash and Equivalents | 882 | 1,154 | 727 | 629 | 712 | 961 | 1,121 | 1,121 | 2,037 | 2,717 |
| Other Current Assets | 2,583 | 2,676 | 2,663 | 2,754 | 2,879 | 2,666 | 2,780 | 2,780 | 2,817 | 2,925 |
| **Total Current Assets** | **3,465** | **3,830** | **3,390** | **3,383** | **3,591** | **3,628** | **3,901** | **3,901** | **4,854** | **5,642** |
| Net PP&E | 1,318 | 1,307 | 1,381 | 1,368 | 1,355 | 1,372 | 1,389 | 1,389 | 1,464 | 1,544 |
| Other Assets | 1,805 | 2,776 | 2,878 | 2,898 | 2,863 | 2,842 | 2,821 | 2,821 | 2,789 | 2,759 |
| **Total Assets** | **6,588** | **7,913** | **7,649** | **7,649** | **7,809** | **7,842** | **8,111** | **8,111** | **9,106** | **9,945** |
| Current Liabilities | 1,086 | 1,781 | 1,117 | 1,730 | 1,784 | 1,735 | 1,865 | 1,865 | 1,195 | 1,772 |
| Non-Current Liabilities | 4,165 | 5,041 | 5,033 | 4,284 | 4,272 | 4,273 | 4,274 | 4,274 | 5,278 | 4,782 |
| **Total Liabilities** | **5,251** | **6,822** | **6,150** | **6,014** | **6,056** | **6,008** | **6,139** | **6,139** | **6,473** | **6,554** |
| **Total Shareholders' Equity** | **1,337** | **1,091** | **1,499** | **1,635** | **1,746** | **1,833** | **1,972** | **1,972** | **2,633** | **3,390** |
| **Cash Flow Statement** | | | | | | | | | | |
| Cash Flow from Operations | 626 | 664 | 713 | 119 | 180 | 667 | 387 | 1,353 | 1,618 | 1,665 |
| Cash Flow from Investing | (187) | (1,115) | (214) | (48) | (40) | (140) | (55) | (283) | (233) | (247) |
| Cash Flow from Financing | (154) | 755 | (903) | (176) | (64) | (271) | (172) | (682) | (470) | (737) |
| **Free Cash Flow to Equity** | **446** | **1,557** | **94** | **77** | **129** | **612** | **332** | **1,150** | **1,635** | **1,417** |

**Zoetis fiscal periods end on Sundays, with the exception of year-end, which is always December 31st*
***Includes amortization, restructuring and M&A costs, net interest expense, and other expenses*
****Includes allocation to non-controlling interests, which are not shown in this table*
*Source: Company Reports and Hilliard Lyons estimates*

Prices of other stocks mentioned: Aratana Therapeutics (PETX - $6.07)
Eli Lilly & Co. (LLY - $81.87; Long-term Buy, $93 PT)

*Additional information is available upon request*

## Analyst Certification

I, Kurt A. Kemper, 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.

**Definitions of 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, typically 2-3 years.
**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.

**Definitions of Suitabilities:**
**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** | 36 | 29% | 14% | 86% |
| **Hold/Neutral** | 79 | 63% | 5% | 95% |
| **Sell** | 10 | 8% | 0% | 100% |

*As of 7 July 2017*

## Other Disclosures

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