



COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

Key Metrics

ZTS - NYSE (as of 01/08/18)	\$74.24
Price Target	\$88.00
52-Week Range	\$52.01 - \$74.42
Shares Outstanding (mm)	492.4
Market Cap. (\$mm)	\$36,176
1-Mo. Average Daily Volume (000's)	599,792
Institutional Ownership	96%
Debt / Total Capital	57.3%
ROE (TTM)	55.9%
Book Value / Share	\$4.10
Price / Book Value	18.1x
Indicated Dividend / Yield	\$0.50 0.7%
TTM Operating Margin	31.7%

Non-GAAP EPS FYE 12/31

		Prior	Curr.	Prior	Curr.
	2016A	2017E	2017E	2018E	2018E
1Q	\$0.48		\$0.53A	\$0.62	\$0.68
2Q	\$0.49		\$0.53A	\$0.66	\$0.73
3Q	\$0.52		\$0.65A	\$0.74	\$0.81
4Q	\$0.47	\$0.64	\$0.64	\$0.68	\$0.75
Year	\$1.96	\$2.35	\$2.35	\$2.71	\$2.97
P/E	37.9x		31.6x		25.0x

Figures may not add up due to rounding

Revenue (\$b)

		Prior	Curr.	Prior	Curr.
	2016A	2017E	2017E	2018E	2018E
1Q	\$1.16		\$1.23A	\$1.32	\$1.32
2Q	\$1.21		\$1.27A	\$1.38	\$1.38
3Q	\$1.24		\$1.35A	\$1.42	\$1.42
4Q	\$1.28	\$1.38	\$1.38	\$1.45	\$1.45
Year	\$4.89	\$5.23	\$5.23	\$5.57	\$5.57

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.

Animal Health

Analyst: Kurt Kemper, CFA
502-588-8446 / kkemper@hilliard.com
Institutional Sales Desk: George Moorin
502-588-9141 / GMoorin@hilliard.com
J.J.B. Hilliard, W.L. Lyons, LLC
January 9, 2018

Zoetis Inc.

ZTS – NYSE – Buy – 2

Adjusting Estimates for Tax Reform

- **Tax Reform Impact:** Zoetis announced tax reform is expected to cause a \$350 million or less charge in 4Q17, with the benefits coming in the form of an effective tax rate between 21% and 22% in 2018. We previously estimated the FY18 effective tax rate to be 29.0%.
- **Updated Estimates:** Our operating EPS estimate for 4Q17 is unchanged, but our GAAP EPS estimate has been lowered to an \$0.11 loss (conservatively assuming a full \$350 million charge) from a \$0.60 profit previously. We increased our FY18 and FY19 GAAP and non-GAAP EPS estimates significantly. Our FY18 non-GAAP EPS estimate now stands at \$2.97, up from \$2.71 previously. Our FY19 non-GAAP EPS estimate is now \$3.29, up from \$2.99 previously.
- **Valuation:** Zoetis closed yesterday at 34.1X trailing operating EPS and 25.9X 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 a DCF model to recognize impressive cash flow generation. Applying the 26.7X multiple to our 4Q18 / 2019 non-GAAP EPS estimate, we derive an \$86 price target. Using an unchanged WACC of 9.3% and a two-stage growth model for free cash flow to equity, we calculate a \$92 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 more conservative 3%. We are weighting the P/E methodology more heavily (75%) at the moment due to lingering uncertainty around the full impact of tax reform; we previously used an equal weighting. We thus derive our \$88 price target, up from \$81. We reiterate our Buy rating.

Note Important Disclosures on pages 4 and 5
Note Analyst Certification on page 4

RISKS & CONSIDERATIONS

Zoetis is well diversified in terms of products, customer base, and geographies. The company's industry has an attractive secular growth profile and the Companion Animal segment is recession-resistant, in our opinion. 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. Additionally, lower consumption of animal protein could hurt Zoetis customers and thereby reduce demand for Zoetis products.
- **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 subject 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 A	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	754	821	2,967	3,129	3,318
Companion Animal	1,632	1,756	1,956	517	568	580	548	2,213	2,391	2,532
Other	50	51	51	11	12	13	11	47	48	49
Total Revenue	4,785	4,765	4,888	1,231	1,269	1,347	1,380	5,227	5,568	5,899
Gross Profit	3,068	3,027	3,222	788	829	912	950	3,479	3,757	4,020
Gross Margin %	64.1%	63.5%	65.9%	64.0%	65.3%	67.7%	68.9%	66.6%	67.5%	68.2%
SG&A	1,643	1,532	1,364	309	336	328	350	1,323	1,349	1,426
R&D	396	364	376	90	86	96	109	381	396	409
Core Operating Income	1,029	1,131	1,482	389	407	488	491	1,775	2,012	2,185
Core Operating Margin %	21.5%	23.7%	30.3%	31.6%	32.1%	36.2%	35.6%	34.0%	36.1%	37.0%
Non-core Expenses**	209	586	254	52	62	75	73	262	265	262
GAAP Pretax Income	820	545	1,228	337	345	413	418	1,513	1,747	1,923
GAAP Pretax Margin %	17.1%	11.4%	25.1%	27.4%	27.2%	30.7%	30.3%	28.9%	31.4%	32.6%
Effective Tax Rate	28.4%	37.8%	33.3%	29.1%	28.4%	28.3%	112.7%	51.8%	21.5%	21.4%
GAAP Net Income***	583	339	821	238	247	298	(53)	730	1,370	1,510
Non-GAAP Adjustments	207	550	154	23	14	24	369	430	82	82
Non-GAAP Net Income	790	889	975	261	261	322	316	1,160	1,452	1,592
Diluted Shares O/S	502.0	502.0	498.2	495.3	494.0	492.4	491.3	493.2	488.4	484.4
GAAP Diluted EPS	\$ 1.16	\$ 0.68	\$ 1.65	\$ 0.48	\$ 0.50	\$ 0.61	\$ (0.11)	\$ 1.48	\$ 2.81	\$ 3.12
Non-GAAP Diluted EPS	\$ 1.57	\$ 1.77	\$ 1.96	\$ 0.53	\$ 0.53	\$ 0.65	\$ 0.64	\$ 2.35	\$ 2.97	\$ 3.29
Dividends per share	\$ 0.288	\$ 0.332	\$ 0.380	\$ 0.105	\$ 0.105	\$ 0.105	\$ 0.105	\$ 0.420	\$ 0.504	\$ 0.600
Balance Sheet										
Cash and Equivalents	882	1,154	727	629	712	1,988	2,105	2,105	2,151	3,022
Other Current Assets	2,583	2,676	2,663	2,754	2,879	2,913	2,701	2,701	2,834	2,940
Total Current Assets	3,465	3,830	3,390	3,383	3,591	4,901	4,806	4,806	4,985	5,962
Net PP&E	1,318	1,307	1,381	1,368	1,355	1,388	1,404	1,404	1,480	1,562
Other Assets	1,805	2,776	2,878	2,898	2,863	3,006	2,983	2,983	2,941	2,903
Total Assets	6,588	7,913	7,649	7,649	7,809	9,295	9,193	9,193	9,407	10,427
Current Liabilities	1,086	1,781	1,117	1,730	1,784	1,746	1,881	1,881	1,251	1,822
Non-Current Liabilities	4,165	5,041	5,033	4,284	4,272	5,523	5,524	5,524	5,528	5,032
Total Liabilities	5,251	6,822	6,150	6,014	6,056	7,269	7,405	7,405	6,779	6,854
Total Shareholders' Equity	1,337	1,091	1,499	1,635	1,746	2,019	1,788	1,788	2,627	3,573
Cash Flow Statement										
Cash Flow from Operations	626	664	713	119	180	439	343	1,081	1,758	1,877
Cash Flow from Investing	(187)	(1,115)	(214)	(48)	(40)	(128)	(55)	(271)	(237)	(251)
Cash Flow from Financing	(154)	755	(903)	(176)	(64)	956	(171)	545	(1,475)	(756)
Free Cash Flow to Equity	446	1,557	94	77	129	1,622	288	2,116	771	1,627
<p>*Zoetis fiscal periods end on Sundays, with the exception of year-end, which is always December 31st</p> <p>**Includes amortization, restructuring and M&A costs, net interest expense, and other expenses</p> <p>***Includes allocation to non-controlling interests, which are not shown in this table</p> <p>Source: Company Reports and Hilliard Lyons estimates</p>										

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.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Rating				
Buy	31	28%	13%	87%
Hold/Neutral	74	66%	9%	91%
Sell	7	6%	0%	100%

As of 6 December 2017

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.

J.J.B. Hilliard, W.L. Lyons, LLC is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as placement agent in private transactions.

The information herein has been obtained from sources we believe to be reliable but is not guaranteed and does not purport to be a complete statement of all material factors. This is for informational purposes and is not a solicitation of orders to purchase or sell securities. Reproduction is forbidden unless authorized. All rights reserved.