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CUBEWEALTH

ZOETIS EQUITY REPORT

JANUARY 14TH, 2020

ZOETIS SUMMARY

BY THE NUMBERS

TICKER: ZTS
PRICE: $136.51

Zoetis Inc. discovers, develops, manufactures, and commercializes animal health medicines, vaccines, and diagnostic products in the United States and internationally. It commercializes products primarily across species, including livestock, such as cattle, swine, poultry, fish, and sheep; and companion animals comprising dogs, cats, and horses.

The company was founded in 1952 and is headquartered in Parsippany, New Jersey.

0.60%
DIVIDEND YIELD

+59.6%
Y/Y RETURN

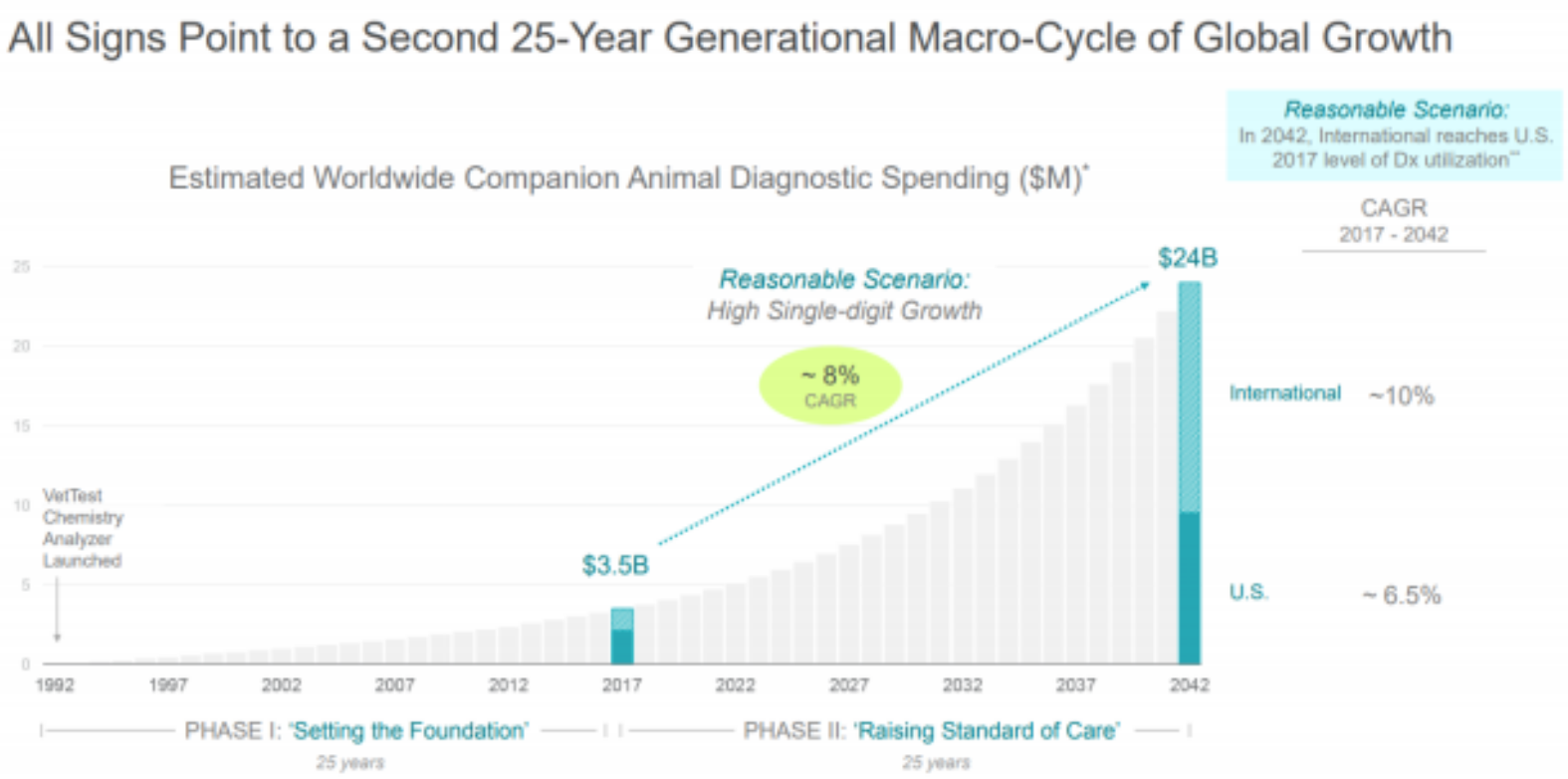
$65B
MARKET CAP

ANALYSIS

Zoetis (ZTS) is the largest pharmaceutical company on the public markets that specializes in pet and animal care. The company boasts a massive $65B valuation and has seen its stock skyrocket over 362% since hitting the public markets in early 2013 as part of a spin off from Pfizer.

What makes ZTS such a unique investment is the space in which it operates. In the U.S. alone, analysts estimate Americans spent a whopping $75.4B on their pets in 2019, up from $72.5B in 2018. For a greater idea of the growth trajectory, in 1994 this amount was only $17B driven by a huge influx of pet ownership in the States.

Here are some more stats on the market. Analysts also believe that the world will spend up to $24B in animal diagnostics alone by 2042, a compounded annual growth rate from 2017 of roughly 8% driven by a stronger adoption abroad.

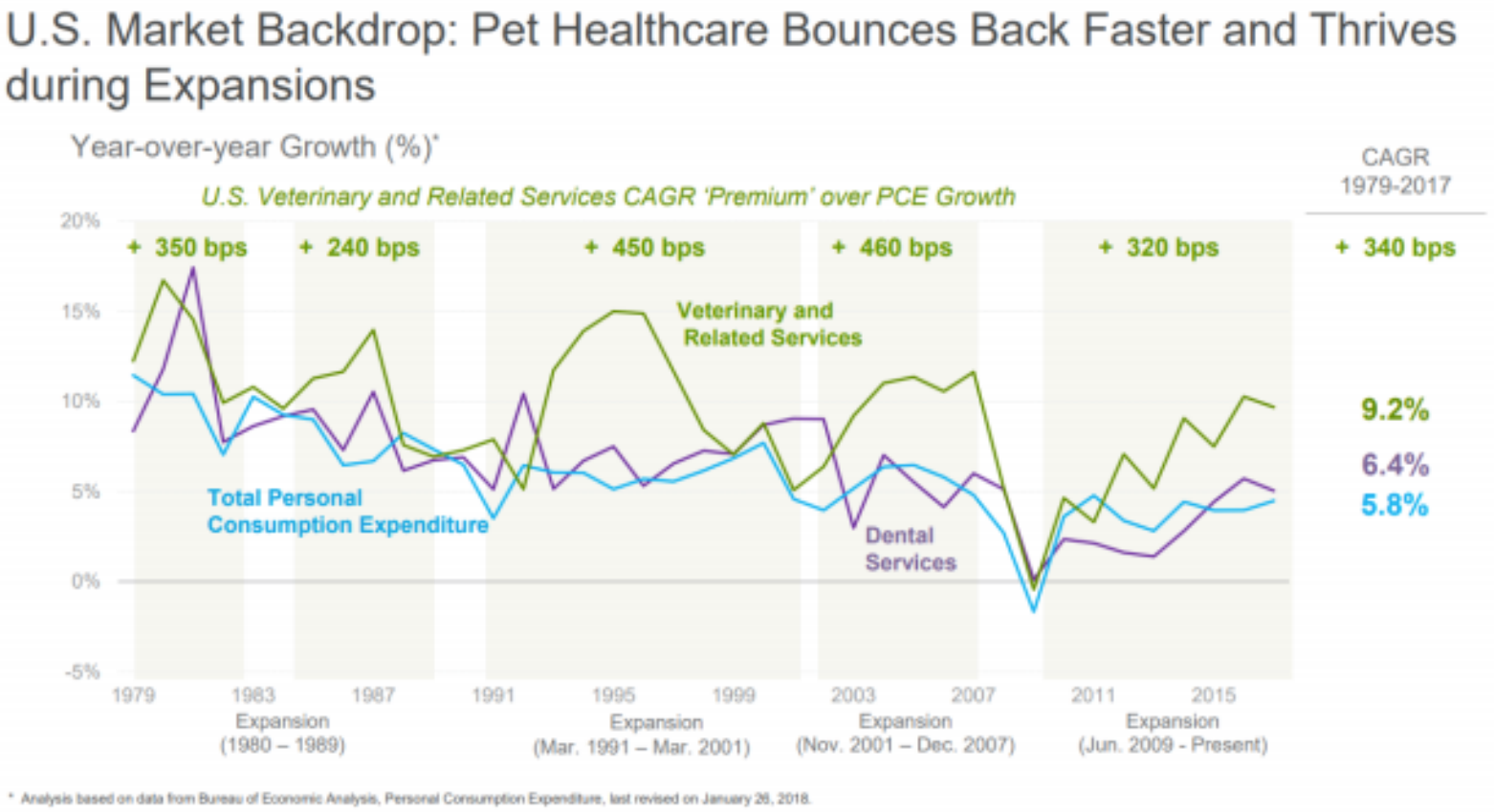


In addition, we see a deeper breakdown of that spend. Of the $75.4B spent in 2019, approximately $31.7B is on food, $16.4B on supplies, $19B on vet care, and $6.3B on services which I imagine includes grooming and other activities.

Historical Totals (2009-2019)

Category	2019 Est. ($ Billion)	2018 Act. ($ Billion)	2017 Act. ($ Billion)	2016 Act. ($ Billion)	2015 Act. ($ Billion)	2014 Act. ($ Billion)	2013 Act. ($ Billion)	2012 Act. ($ Billion)	2011 Act. ($ Billion)	2010 Act. ($ Billion)	2009 Act. ($ Billion)
Food	31.68	30.32	29.07	28.23	23.05	22.26	21.57	20.64	19.85	18.76	17.56
Supplies/OTC Med.	16.44	16.01	15.11	14.71	14.28	13.75	13.14	12.65	11.77	10.94	10.41
Veterinary Care	18.98	18.11	17.07	15.95	15.42	15.04	14.37	13.67	13.41	13.01	12.04
Live Animal Sales	1.97	2.01	2.1	2.1	2.12	2.15	2.23	2.21	2.14	2.13	2.16
Other Services	6.31	6.11	6.16	5.76	5.41	4.84	4.41	4.16	3.79	3.51	3.36
Total	75.38	72.56	69.51	66.75	60.28	58.04	55.72	53.33	50.96	48.35	45.53
% Growth vs Prev. Yr	3.9	4.4	4.1	10.7	3.9	4.2	4.5	4.7	5.4	6.2	5.4

It's completely apparent today that pets are becoming more and more a staple to households in America and that people all over the world are willing to spend their hard-earned dollars to take care of them regardless of the economic backdrop.



Not only has this space outperformed total personal consumption growth in economic expansions, it has also shown greater resiliency during economic downturns. Look at 2008-2009 for instance. The year beforehand the industry grew at 10% Y/Y while dental services and total personal consumption only grew at half that pace. Fast forward to the Great Recession, and instead of showing greater volatility during tough times, the vet industry stayed flat Y/Y and has witnessed a CAGR of 9.2% from 1979-2017. Put simply, the space rips stronger in good times and dips less during tough times - a win/win situation for investors and the company.

CUBE'S TOP PROS FOR ZTS

STEADY & PREDICTABLE REVENUE GROWTH

ECONOMIC RESILIENCY

SUPERIOR MARGINS

CUBE'S TOP CONS FOR ZTS

LOFTY VALUATION

CURRENCY EXPOSURE

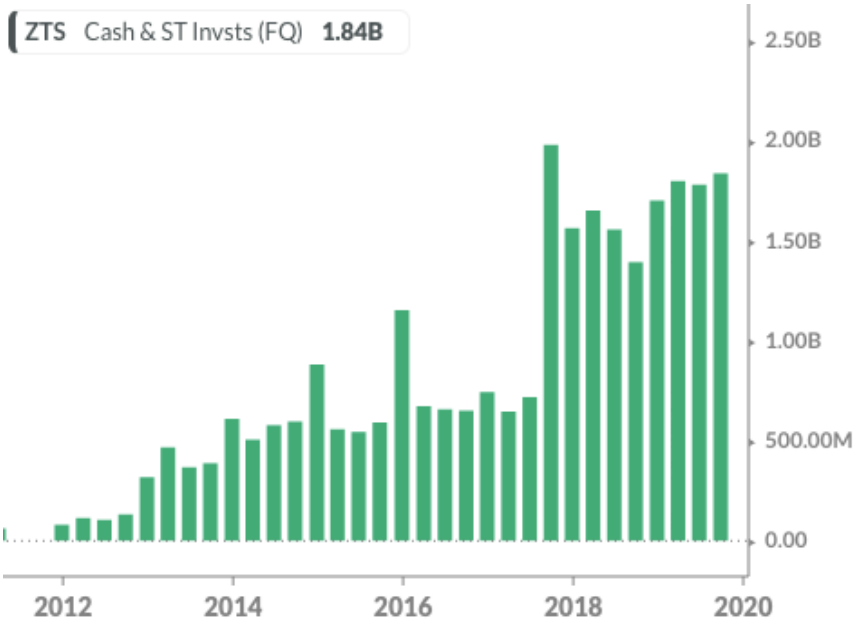
SIZABLE DEBT

FINANCIAL STATEMENTS

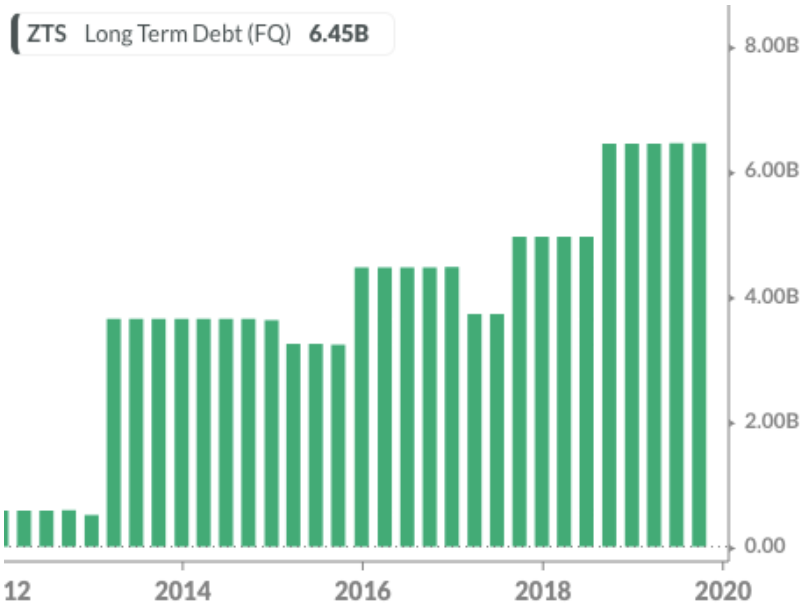
BALANCE SHEET

(MILLIONS OF DOLLARS, EXCEPT SHARE AND PER SHARE DATA)	September 30, 2019 (Unaudited)	December 31, 2018
Assets		
Cash and cash equivalents[a]	$ 1,815	$ 1,602
Short term investments	12	99
Accounts receivable, less allowance for doubtful accounts of $25 in 2019 and $24 in 2018	1,030	1,036
Inventories	1,439	1,391
Other current assets	322	271
Total current assets	4,618	4,399
Property, plant and equipment, less accumulated depreciation of $1,725 in 2019 and $1,599 in 2018	1,813	1,658
Operating lease right of use assets	193	—
Goodwill	2,550	2,519
Identifiable intangible assets, less accumulated amortization	1,935	2,046
Noncurrent deferred tax assets	72	61
Other noncurrent assets	91	94
Total assets	$ 11,272	$ 10,777
Liabilities and Equity		
Short-term borrowings	$ —	$ 9
Accounts payable	284	313
Dividends payable	—	79
Accrued expenses	451	487
Accrued compensation and related items	217	266
Income taxes payable	52	35
Other current liabilities	48	34
Total current liabilities	1,052	1,223
Long-term debt, net of discount and issuance costs	6,447	6,443
Noncurrent deferred tax liabilities	473	474
Operating lease liabilities	169	—
Other taxes payable	255	265
Other noncurrent liabilities	198	187
Total liabilities	8,594	8,592
Commitments and contingencies (Note 16)		
Stockholders' equity:		
Preferred stock, $0.01 par value: 1,000,000,000 authorized, none issued	—	—
Common stock, $0.01 par value: 6,000,000,000 authorized; 501,891,243 and 501,891,243 shares issued; 476,745,789 and 479,562,326 shares outstanding at September 30, 2019, and December 31, 2018, respectively	5	5
Treasury stock, at cost, 25,145,454 and 22,328,917 shares of common stock at September 30, 2019, and December 31, 2018, respectively	(1,876)	(1,487)
Additional paid-in capital	1,031	1,026
Retained earnings	4,217	3,270
Accumulated other comprehensive loss	(699)	(629)
Total equity	2,678	2,185
Total liabilities and equity	$ 11,272	$ 10,777

When we look at ZTS' balance sheet it's nothing to be too concerned about but it's also not bulletproof. The company has done a good job growing their cash and short-term equivalents from $500M back in 2017 to nearly $2B today. During 2019 there wasn't much of a change to this figure, though.

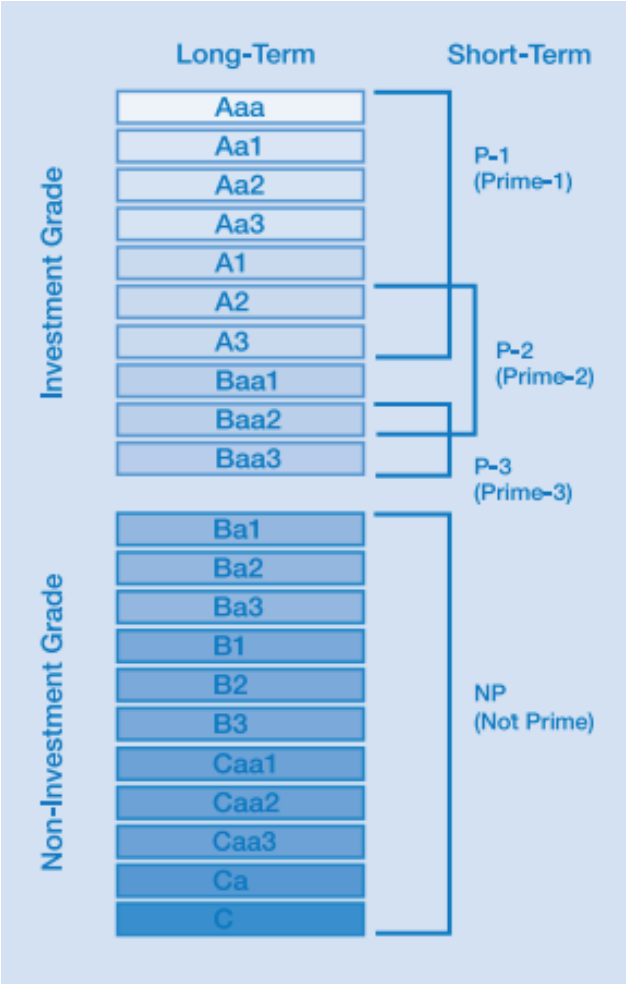


While cash has grown, so has debt. ZTS now has close to $6.5B in debt, which is over 3x their cash amount. The good news here is that the company doesn't have any short-term borrowings due. In other words, all of these debts are due in longer than a year.



As we'll see in the coming slides, this debt equates to roughly $55M a quarter in interest expenses. CUBE sees this as manageable but really don't want to see this level grow from here.

Earlier in 2019, Moody's rated ZTS with a Baa1 credit rating which is towards the bottom of investment grade quality. This isn't something to panic about but Moody's did mention their net debt to EBITDA ratio as something on the higher side and the reason for the valuation. In order for ZTS to hold this rating and avoid getting closer to junk rated, they will need to control their debt levels and begin to pay them down. CUBE does not anticipate ZTS moving down to junk rating, we are just saying this should be watched given the consistent rise since 2012. It also means that ZTS will also have to be more reluctant to acquire anymore companies as they spent $2B to acquire Abaxis in 2018. They have made some recent acquistions like that of Pheonix Labs to make more headway into the diagnostic business but the terms were undisclosed. As we mentioned in the beginning of the report, this is a big growth market.



FINANCIAL STATEMENTS

INCOME STATEMENT

(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	Three Months Ended September 30, 2019	Three Months Ended September 30, 2018	Nine Months Ended September 30, 2019	Nine Months Ended September 30, 2018
Revenue	$ 1,584	$ 1,480	$ 4,586	$ 4,261
Costs and expenses:				
Cost of sales	479	473	1,462	1,367
Selling, general and administrative expenses	391	367	1,166	1,064
Research and development expenses	112	108	325	307
Amortization of intangible assets	38	32	115	78
Restructuring charges and certain acquisition-related costs	6	47	33	54
Interest expense, net of capitalized interest	56	54	167	147
Other (income)/deductions—net	(26)	(19)	(46)	(28)
Income before provision for taxes on income	528	418	1,364	1,272
Provision for taxes on income	95	71	248	193
Net income before allocation to noncontrolling interests	433	347	1,116	1,079
Less: Net loss attributable to noncontrolling interests	—	—	—	(4)
Net income attributable to Zoetis Inc.	$ 433	$ 347	$ 1,116	$ 1,083
Earnings per share attributable to Zoetis Inc. stockholders:				
Basic	$ 0.91	$ 0.72	$ 2.33	$ 2.24
Diluted	$ 0.90	$ 0.71	$ 2.31	$ 2.22
Weighted-average common shares outstanding:				
Basic	477.8	482.0	478.7	483.9
Diluted	481.5	485.8	482.3	487.7
Dividends declared per common share	$ —	$ —	$ 0.328	$ 0.252

Revenue by major species

(MILLIONS OF DOLLARS)	Three Months Ended September 30, 2019	Three Months Ended September 30, 2018	Nine Months Ended September 30, 2019	Nine Months Ended September 30, 2018
U.S.				
Livestock	$ 294	$ 322	$ 847	$ 885
Companion animal	550	435	1,495	1,183
	844	757	2,342	2,068
International				
Livestock	437	456	1,315	1,397
Companion animal	284	253	866	766
	721	709	2,181	2,163
Contract manufacturing & human health	19	14	63	30
Total Revenue	$ 1,584	$ 1,480	$ 4,586	$ 4,261

In ZTS' most recent quarter, the company posted Q3 Non-GAAP EPS of $0.94 beating estimates by $0.06 on revenue of $1.58B (+6.8% Y/Y) in-line with estimates.

- Revenue in the U.S. segment was $844 million, an increase of 11% compared with the third quarter of 2018
- Revenue in the International segment was $721 million, an increase of 2% on a reported basis and an increase of 5% operationally compared with the third quarter of 2018
- Net income: $433M (+24.8%)
- EPS: $0.90 (+26.4%)
- Increased 2019 guidance:
  - Revenue: $6.200B - 6.250B from $6.175B - 6.275B
  - EPS: $2.99 - 3.08 from $2.93 - 3.04

This was a pretty solid report from ZTS. The company realized great growth in the United States which picked up some slack from the lag in International revenues.

	Third Quarter				
	2019*	2018*	Change	Foreign Exchange	Operational[1]
Revenue	$1,584	$1,480	7%	(2)%	9%
Adjusted Cost of Sales[2]	473	463	2%	(6)%	8%
as a percent of revenue[3]	*29.9%*	*31.3%*	*NA*	*NA*	*NA*
Adjusted SG&A Expenses[2]	373	356	5%	(2)%	7%
Adjusted R&D Expenses[2]	112	108	4%	-	4%
Adjusted Operating Expenses[4]	489	467	5%	(1)%	6%
Effective Tax Rate on Adjusted Income[2]	20.5%	19.2%	*NA*	*NA*	*NA*
Adjusted Net Income[2]	455	403	13%	3%	10%

The company's net income margins rose to 27.3% from 24% last quarter and 23.4% in the quarter last year.

Livestock sales were disappointing as they fell 9% Y/Y in the United States and fell 4% internationally. The good thing is that their companion animal segment, which we covered in the beginning pages, pulled a lot of weight. In fact, companion revenue in the U.S. grew a whopping 26% Y/Y and 12% internationally.

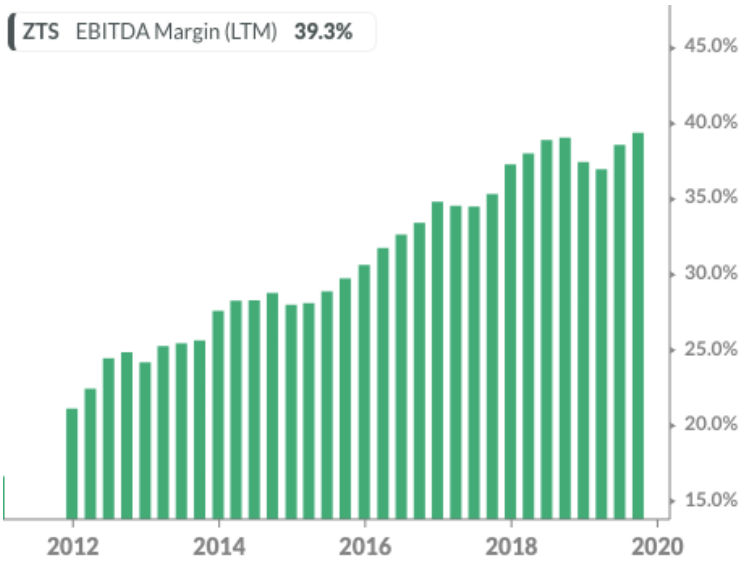
Speaking of global revenues, one of ZTS' risks are how much currency exposure they have. Below you'll see that FX hurt their revenues by 3% in Q3 and with $720.7M in foreign revenues that makes up nearly half of all revs.

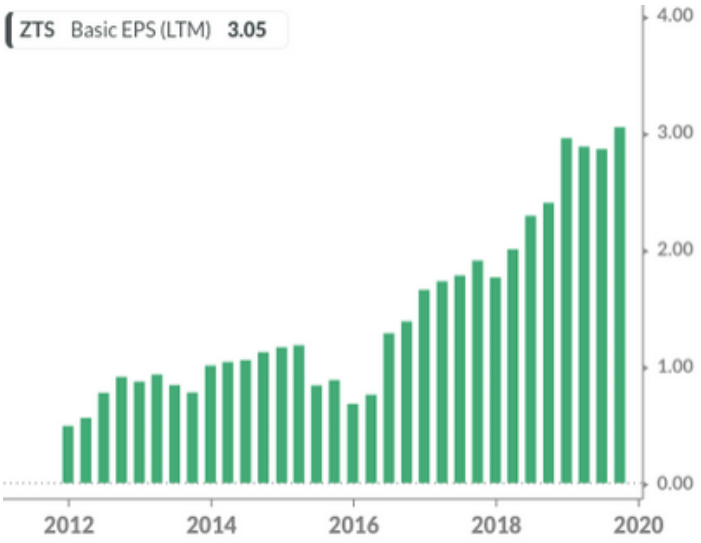
If the dollar continues to strengthen, this could be a bit of an issue for ZTS. Currency impacted every single country negatively for the quarter except Japan. Also, if it weren't for Mexico and Japan, it would have been a pretty brutal quarter for international revenues as France saw a drop in revs of 18% alongside China with a 13% drop.

	Third Quarter				
	2019*	2018*	Change	Foreign Exchange	Operational[1]
Total International	$720.7	$708.8	2%	(3)%	5%
Australia	52.7	53.3	(1)%	(7)%	6%
Brazil	71.8	72.2	(1)%	(2)%	1%
Canada	46.7	42.4	10%	(1)%	11%
China	40.2	46.1	(13)%	(4)%	(9)%
France	23.6	28.8	(18)%	(3)%	(15)%
Germany	35.1	36.0	(3)%	(4)%	1%
Italy	26.2	26.5	(1)%	(4)%	3%
Japan	39.2	34.1	15%	3%	12%
Mexico	29.2	23.9	22%	-	22%
Spain	29.1	27.8	5%	(4)%	9%
United Kingdom	46.4	46.9	(1)%	(6)%	5%
Other Developed	97.5	97.7	-	(4)%	4%
Other Emerging	183.0	173.1	6%	(4)%	10%

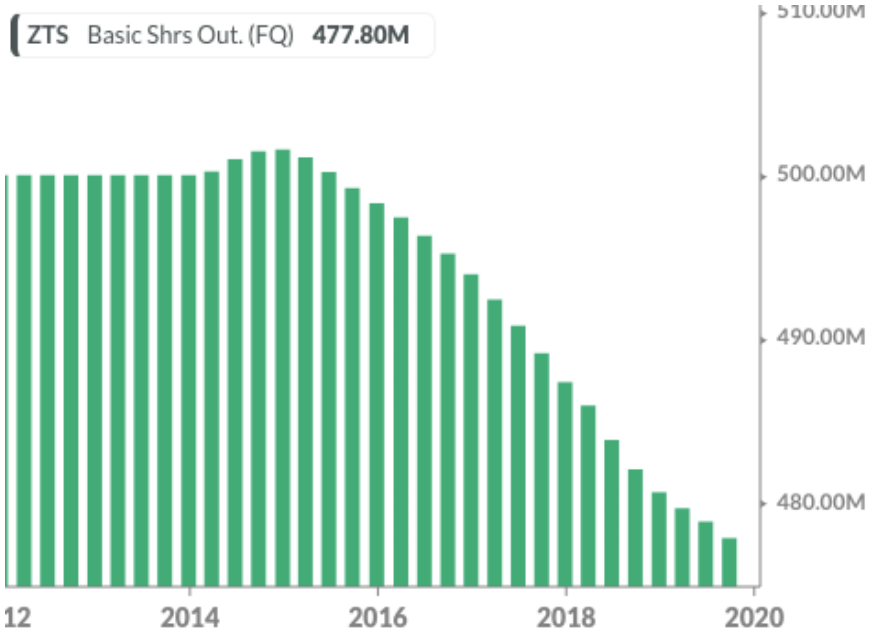
* Millions of dollars

As already alluded to earlier and in the pros section, ZTS has done a great job growing margins especially when compared to their competition. EBITDA margins have grown from 20% to nearly 40% from 2012 to today.





The margin expansion has allowed ZTS to send more to their bottom line as EPS over the last twelve months has crossed the $3.00 mark. This is not only from increasing revenues and margins but also because ZTS has been buying back their shares a little bit.



FINANCIAL STATEMENTS

CASH FLOW

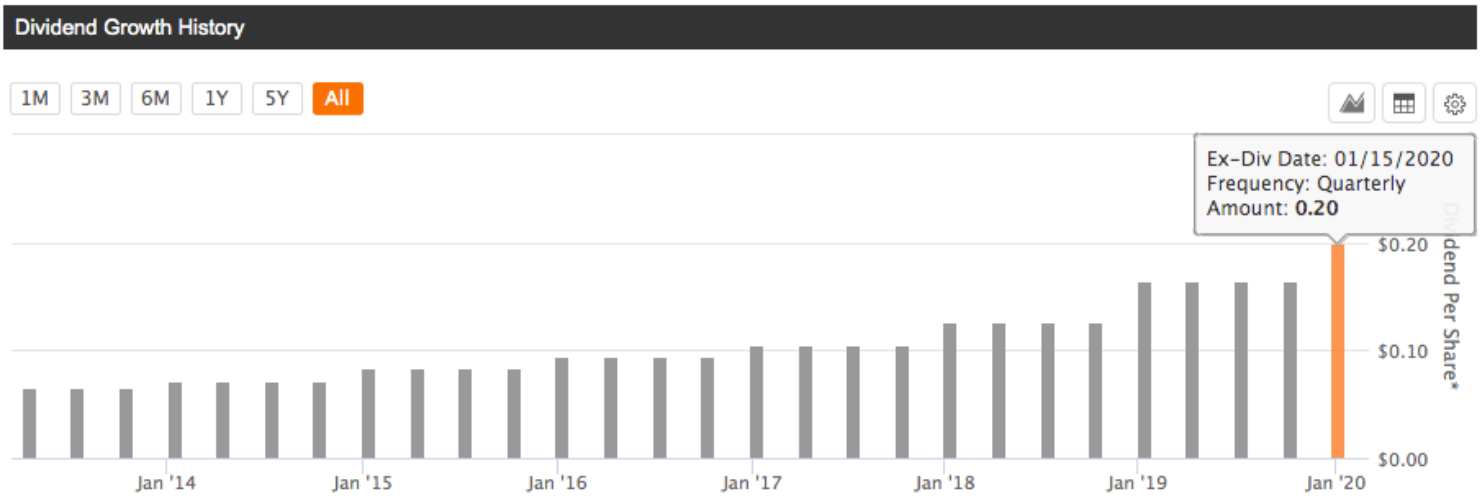
(MILLIONS OF DOLLARS)	Nine Months Ended September 30, 2019	2018
Operating Activities		
Net income before allocation to noncontrolling interests	$ 1,116	$ 1,079
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	303	207
Share-based compensation expense	51	36
Asset write-offs and asset impairments	6	4
Net gain on sale of assets	(20)	—
Provision for losses on inventory	44	37
Deferred taxes[a]	(30)	(155)
Employee benefit plan contribution from Pfizer Inc.	2	2
Other non-cash adjustments	(11)	(17)
Other changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	(18)	37
Inventories	(103)	29
Other assets	(39)	(77)
Accounts payable	(28)	(39)
Other liabilities	(68)	(31)
Other tax accounts, net[a]	8	94
Net cash provided by operating activities	1,213	1,206
Investing Activities		
Capital expenditures	(294)	(200)
Acquisition of Abaxis, net of cash acquired	—	(1,884)
Other acquisitions	(137)	(110)
Proceeds from maturities and redemptions of investments	89	—
Net proceeds on swaps designated as net investment hedges	37	—
Net proceeds from sale of assets	20	8
Other investing activities	(6)	1
Net cash used in investing activities	(291)	(2,185)
Financing Activities		
Decrease in short-term borrowings, net	(9)	—
Proceeds from issuance of long-term debt—senior notes, net of discount and fees	—	1,485
Payment of contingent consideration related to previously acquired assets	(9)	(12)
Acquisition of a noncontrolling interest	—	(26)
Share-based compensation-related proceeds, net of taxes paid on withholding shares	2	14
Purchases of treasury stock	(450)	(548)
Cash dividends paid	(235)	(183)
Net cash (used in)/provided by financing activities	(701)	730
Effect of exchange-rate changes on cash and cash equivalents	(8)	(29)
Net increase/(decrease) in cash and cash equivalents	213	(278)
Cash and cash equivalents at beginning of period	1,602	1,564
Cash and cash equivalents at end of period	$ 1,815	$ 1,286

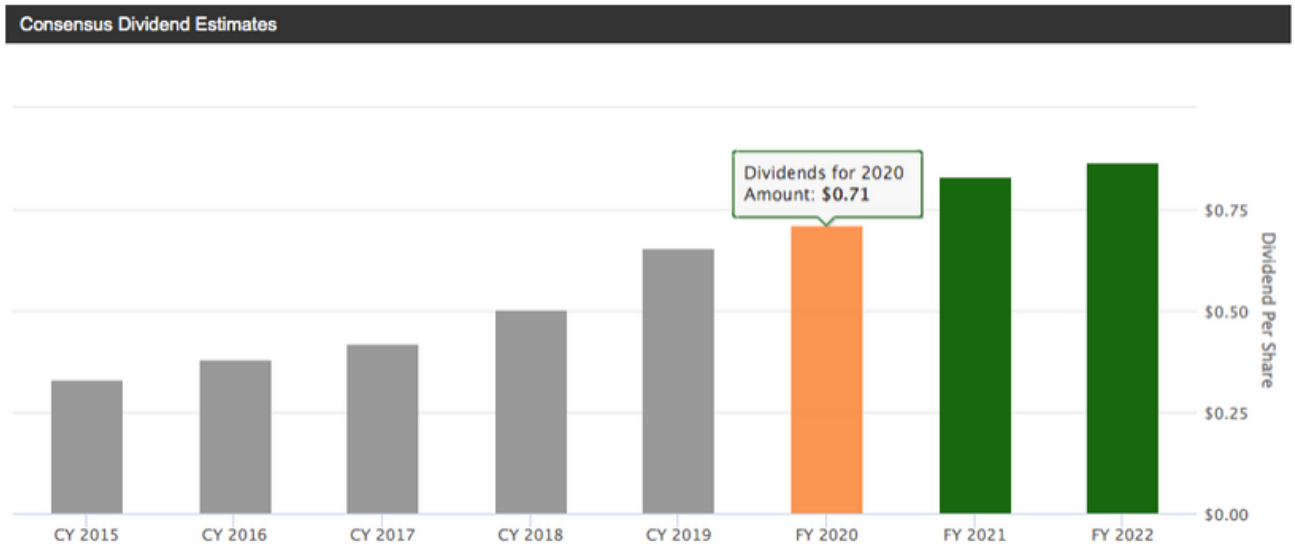
For the first 9 months we know that ZTS has generated $4.5B in revenue. What's impressive is the fact that they were able to convert $1.2B of that into operating free cash flow, or roughly 26.7%. After deducting for capital expenditures of $294M, ZTS has generated free cash flow of $919M three-quarters through the year.

With that remaining cash, ZTS has spent $235M in dividends and $450M in buying back stock.

In the future, we'll see if Zoetis decides to start chipping away at that debt. With a current dividend yield at 0.60% it isn't much but they do blend this with the share buyback program. What happens when the maturities for the debt comes around? Will ZTS simply take out a new line of credit to pay the old line of credit? Does management mind paying 0ver $200M (3.5% of revenue) a year in interest payments?

These are things we need to look out for as ZTS will have to think about what they want to use their free cash flow for in the future. Right now, they don't have any near-term maturities so this is not an issue that needs to be dealt with urgently.





Dividend Growth Summary	
1 Year Growth Rate (TTM)	30.16%
3 Year Growth Rate (CAGR)	19.96%
5 Year Growth Rate (CAGR)	17.90%
10 Year Growth Rate (CAGR)	-
Years of Growth	6 Years

If history is any indicator, ZTS will look to continue their dividend. Over the last 5 years they have averaged a near 18% increase in their dividend Y/Y. Analysts expect the company to pay $0.71 per share in dividends in 2020 followed by $0.83 in 2022, and $0.86 in 2023.

CUBE thinks these estimates are a bit on the conservative side. We expect $0.80 in 2020 and as high as $1.00 by 2023 but most likely closer to $0.95.

SOME OTHER KEY STATS

Total Debt / EBITDA

2.8x

Total Debt to Earnings before Interest, Taxes, Depreciation, Amortization

Return on Assets

11.7%

Quick Ratio

2.7x

Compares the total amount of cash and cash equivalents + marketable securities + accounts receivable to the amount of current liabilities.

2020 Wall Street Rev Growth Expectations

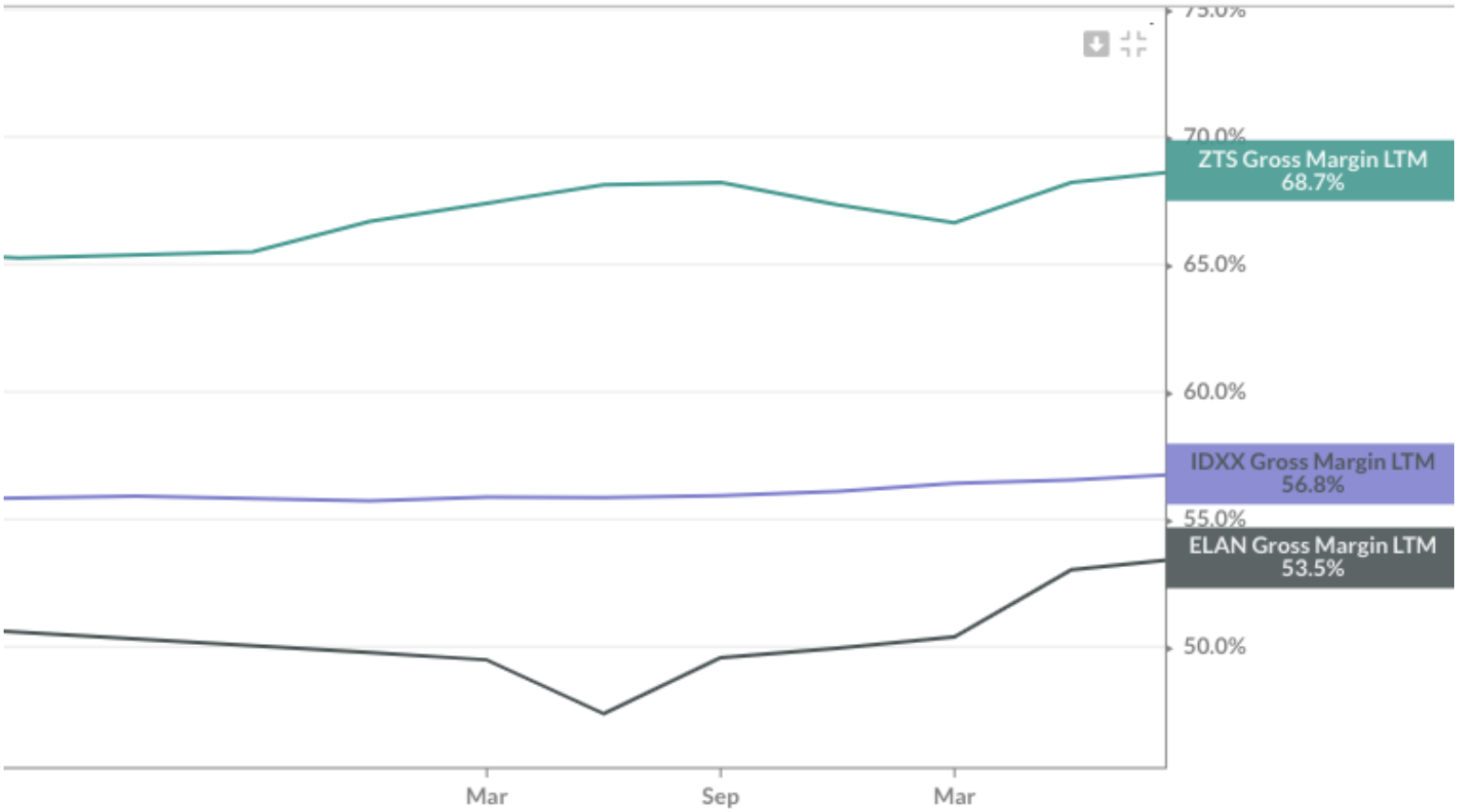
7.4%

ZOETIS FUNDAMENTALS

When comparing fundamentals, CUBE has decided to use the following peers:

1. IDEXX Labs (IDXX) - Check Vault for research on them as well
2. Elanco Animal Health Inc. (ELAN)

Starting at the top with gross margins, we see right off the bat that ZTS commands the lead by a wide margin of approx. 10%

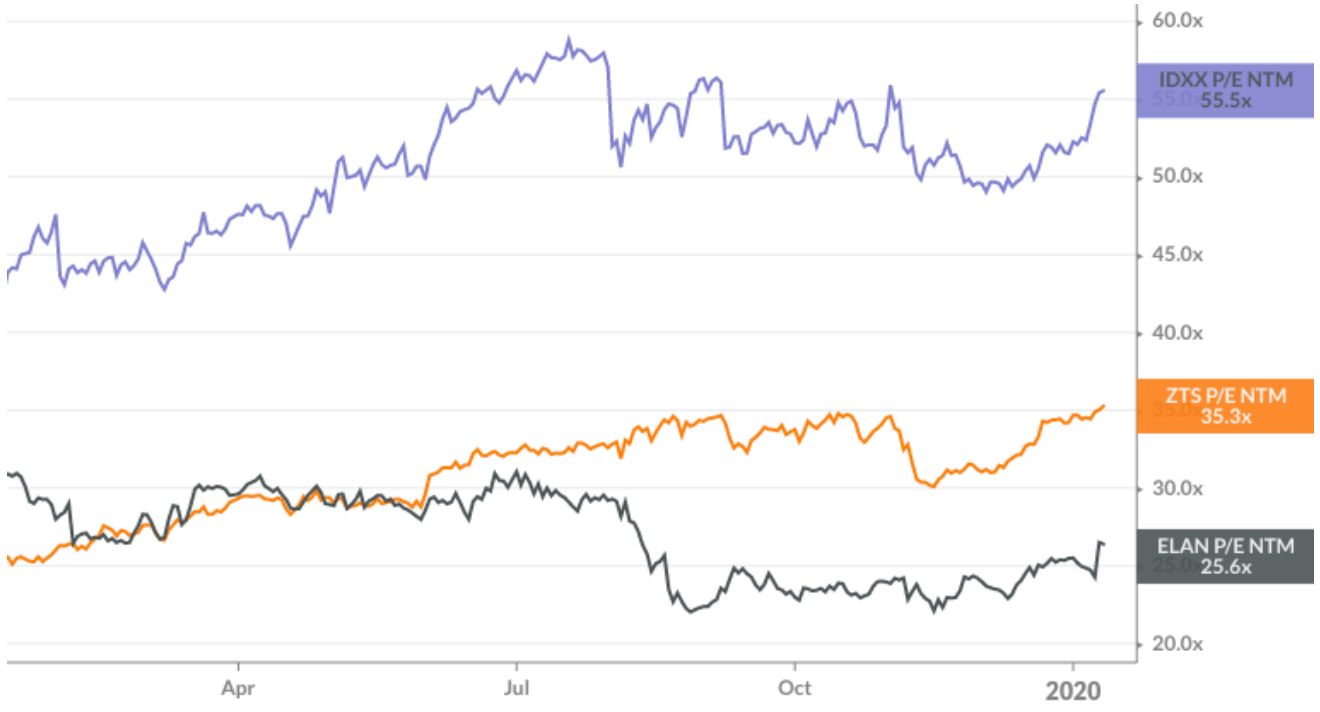


On an enterprise value (market cap + debt - cash) to forward sales, ZTS is slightly more expensive than IDXX. Both are far more expensive than ELAN at 4.1x.

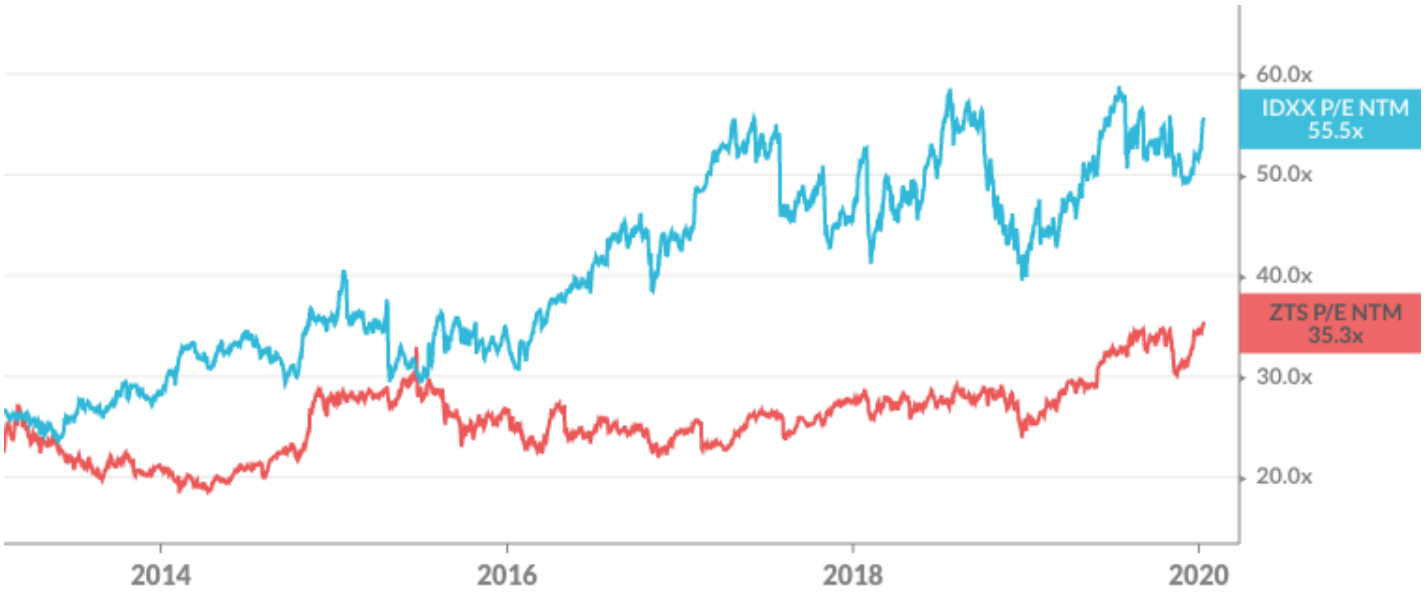
Something to note, these are very high valuations for pharma companies. These are valuations that are generally seen only in the technology industry. For example, MSFT trades at 8.3x and AMD trades at 6.5x

The same applies on a forward EV/EBITDA. Here IDXX trades at 36x while ZTS trades at 25x. For reference to MSFT and AMD again, they trade at 18.9x and 32.6x, respectively.

Moving further down the income statement, on a P/E basis, ZTS trades at 35.3x next year's earnings. While this is lower than IDXX at 55.5x, both companies are pretty expensive at these levels.

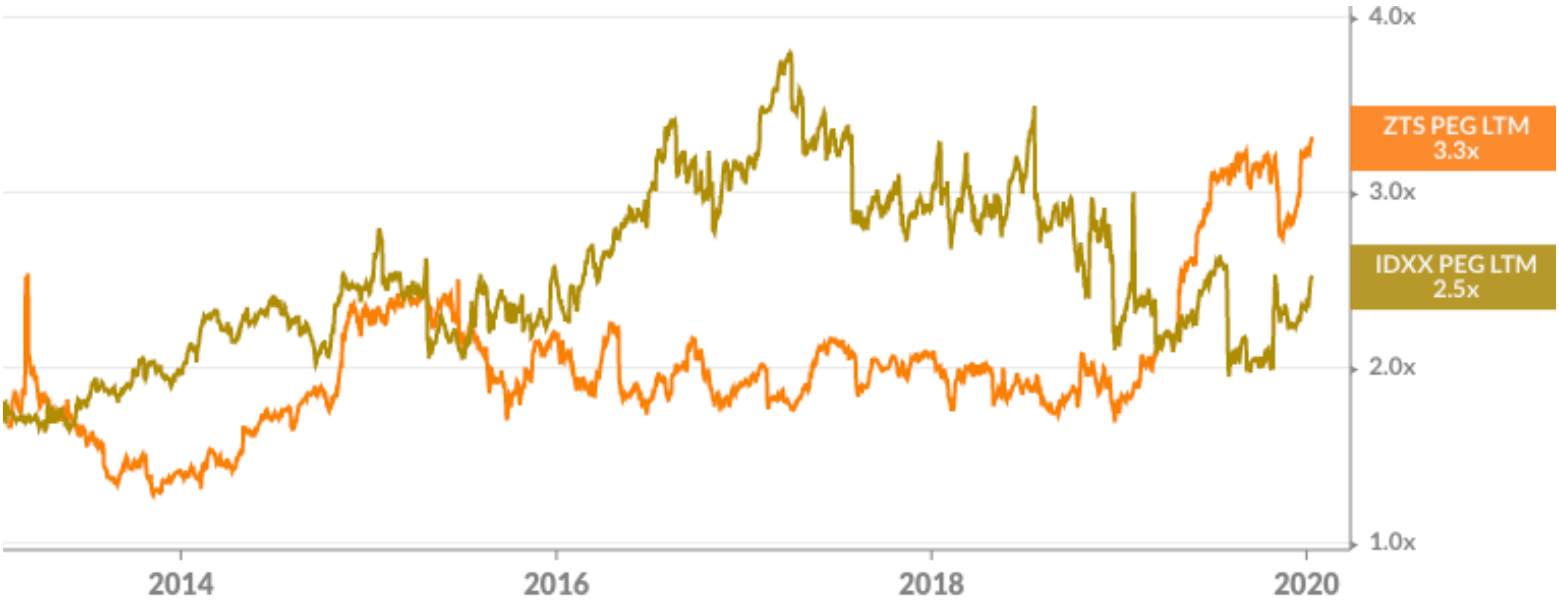


For reference, ZTS and IDXX are trading at levels much higher than usual. We completely understand that multiple expansion is normal and warranted to an extent given their margin expansion and overall growth of the industry but this is beginning to look a little stretched now.

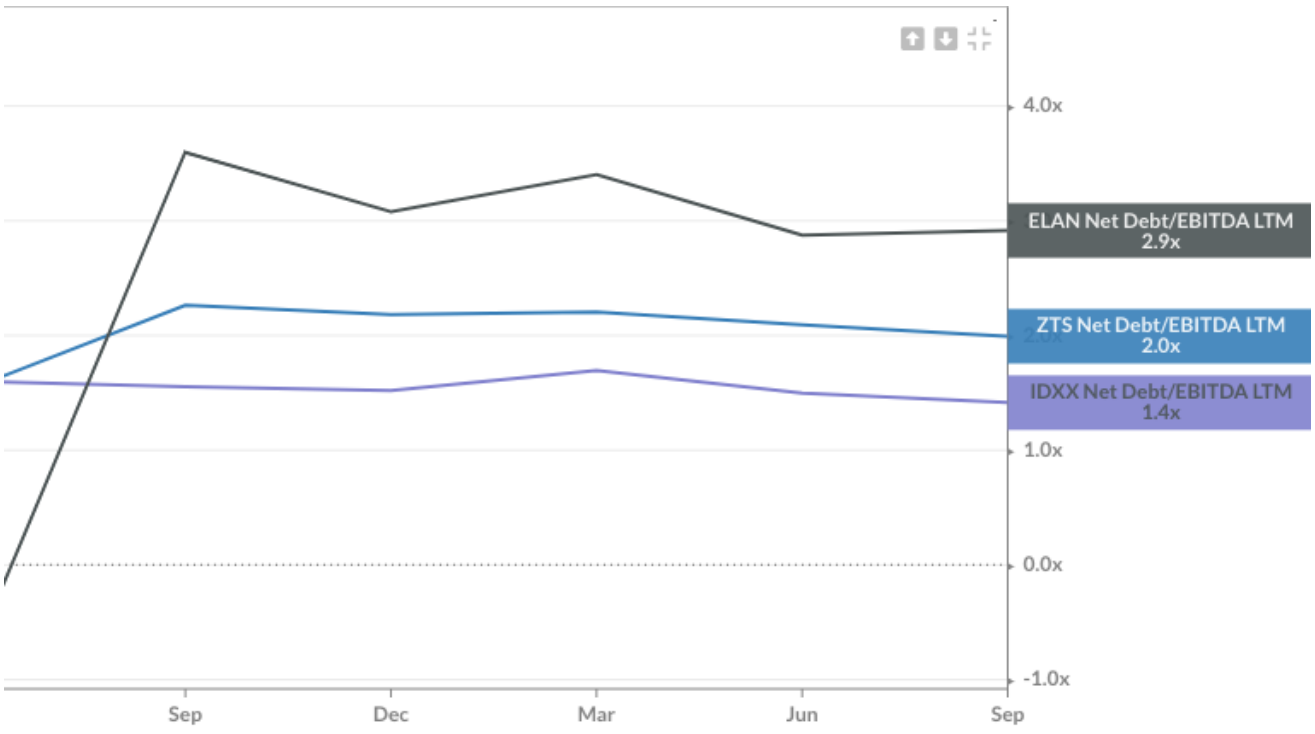


If we take into account future growth, it gives the P/E a little more detail. The PEG ratio is the price to earnings to growth ratio. Generally speaking a ratio under 1 is considered very cheap, between 1-2 is considered fair, and above 2 is normally regarded as rather expensive.

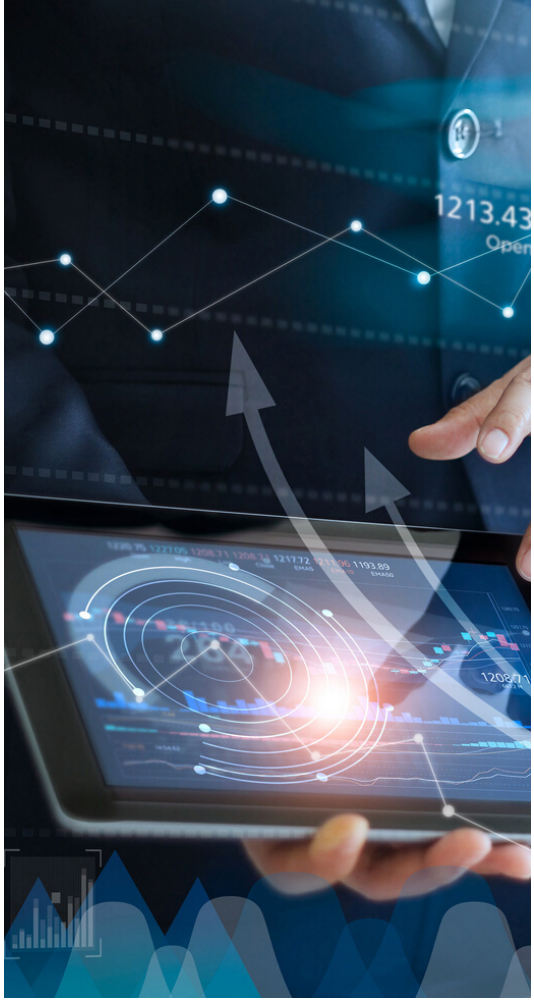
As we can see, ZTS trades at 3.3x and IDXX trades at 2.5x.

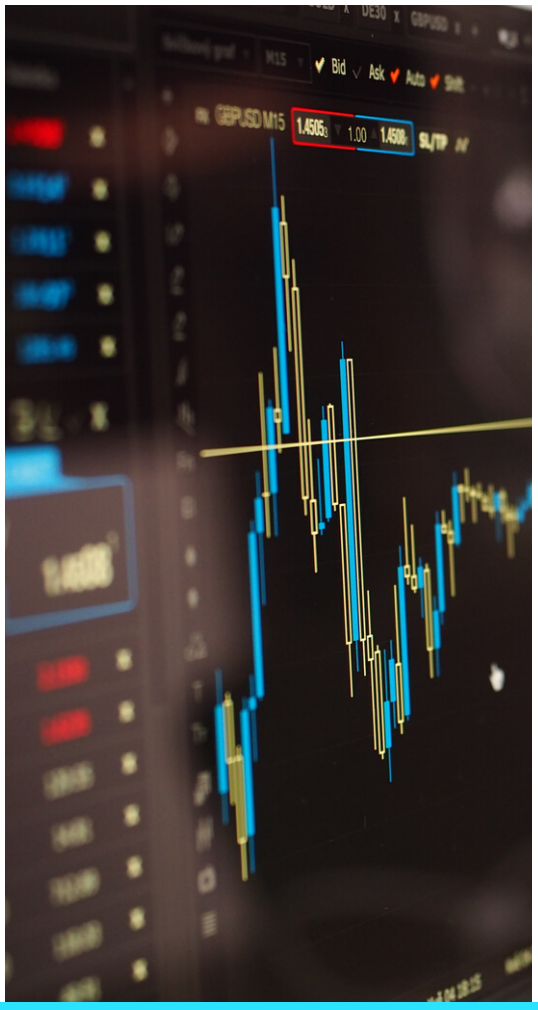


When looking at debt, ZTS is actually middle of the road on a net debt (debt - cash) / EBITDA ratio. ZTS is at 2.0x while ELAN is at 2.9x and IDXX is at 1.4x.



ZOETIS
TECH ANALYSIS





TECH ANALYSIS SUMMARY

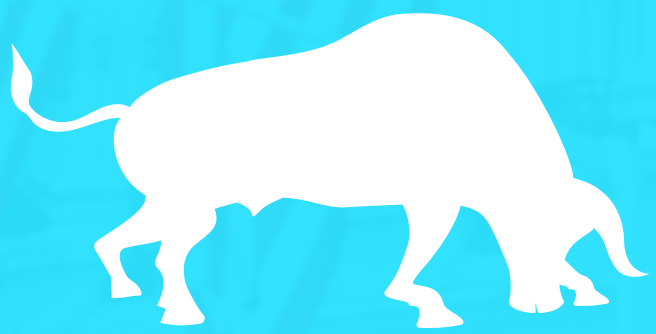
It looks as though there is still some upside left in ZTS. The stock appears to be adamant on grasping that R1 resistance level of $138.01. CUBE believes the stock will then pullback after reaching that point as the W%R, MFI, and RSI are way beyond overbought. The upper BB should also help in containing anymore upside at that $138.36 level.

If that level is indeed rejected, CUBE expects a pullback to the 20DMA and middle bollinger of $131.90.

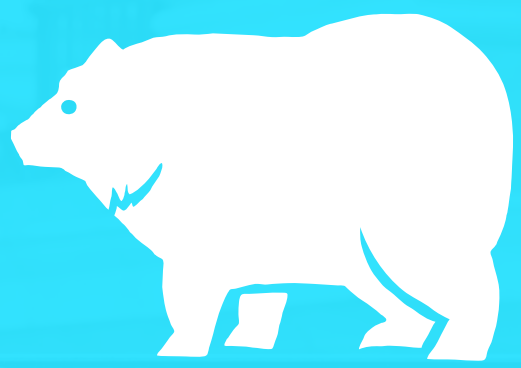
If the stock decides it wants to break past the upper BB and R1, then the R2 is most likely in play at $143.66.

CUBE has trouble seeing a run past this level given where all of the other metrics are. It would take some serious news to make this happen as volume on this recent run up hasn't been that strong.

BULLISH OR BEARISH?



VS.



MORE BULLISH (POSITIVE)

MORE BEARISH (NEGATIVE)

cube

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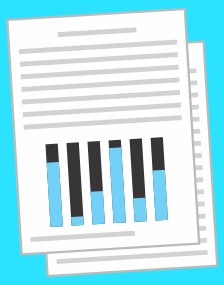

ZTS CONCLUSION

Overall, CUBE is neutral on Zoetis (ZTS). We believe the company is in a great place and will continue to grow revenues at mid-to-high single digits over the next several years but we feel the industry has had its run and most of the returns have been made.

We like the fact that the industry itself is virtually recession proof and that we appear to be taking a stronger liking to animals year over year by socially accept having multiple pets as normal. This simply wasn't the case 20 years ago. We also like that ZTS generates healthy cash flow with excellent margins but this is more of a valuation issue.

If this research was requested at the same time the IDXX research was requested over a year ago we would have said it's a buy in our view and it would have been exactly that. Now we look at both companies as priced for perfection and the risk/reward is no longer as attractive. Both companies are doing an excellent job owning the space and both IDXX and ZTS deserve a premium valuation for a premium industry, but at these tech-like valuations we can no longer get behind a "buy" rating.

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