Zoetis

Health Care
NYSE: ZTS
Market Perform | Hold

June 30, 2024
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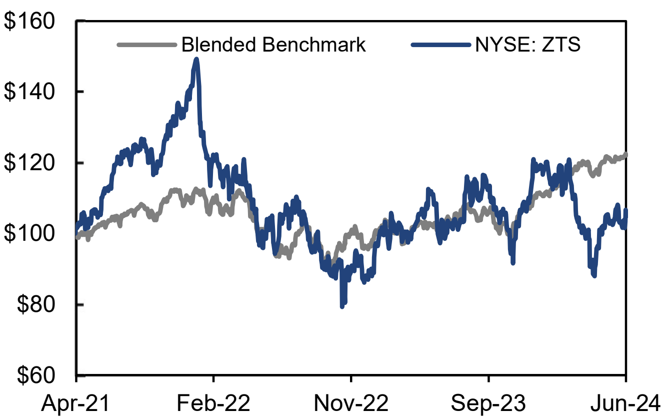
Return on Investment	
Current Share Price	$173.36
Target Price	$177.00
Dividend Yield	0.87%
Implied Return	3%
Conviction Rating	1

Market Profile	
52-Week Range (US$)	$145.62 - $200.50
Market Capitalization (US$mm)	$79,376
Net Debt (US$mm)	$4,848
Minority Interest (US$mm)	$0
Enterprise Value (US$mm)	$84,224
Beta (5-Year Monthly)	0.86

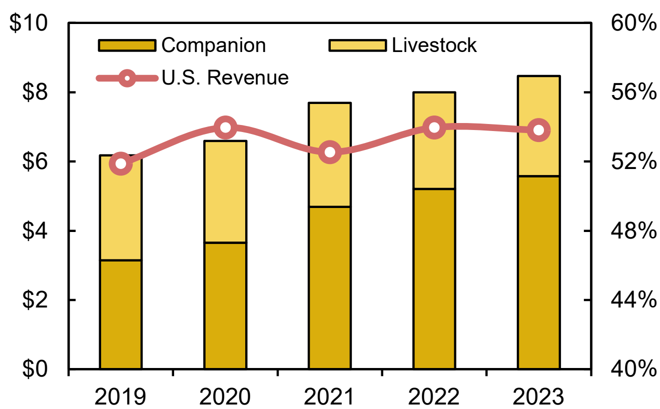
Metrics	2024E	2025E	2026E
Revenue (US$mm)	$9,238	$10,030	$11,002
EBITDA (US$mm)	$4,139	$4,458	$4,907
EPS (US$)	$5.51	$5.97	$6.83
EV/EBITDA	20.5x	19.0x	17.3x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: LHS Segmentation (US$B) vs RHS Revenue (%)



Source: Company Filings

Business Description

Zoetis (NYSE: ZTS) is a leading company in the animal health industry, focusing on the development, production, and distribution of pharmaceutical products. Zoetis operates in more than 100 countries and directly markets its products in 45 countries. The Company operates under two primary segments: (1) Companion Animals and (2) Livestock. The Companion Animal segment includes products that improve the quality and lifespan of dogs, cats, and horses, increasing convenience for pet owners and enhancing veterinarian abilities to provide quality care and efficient services. The Livestock segment covers species such as cattle, swine, poultry, fish, and sheep, focusing on disease prevention and treatment to support the cost-effective production of safe, high-quality animal protein. ZTS offers ~300 product lines across eight major categories: (1) Pharmaceuticals, (2) Vaccines, (3) Parasiticides, (4) Dermatology, (5) Anti-Infectives, (6) Pain and Sedation, (7) Animal Health Diagnostics, and (8) Medicated Feed Additives. The Company generates its remaining revenue through non-pharmaceuticals such as nutritionals, biodevices, genetics, and precision animal health.

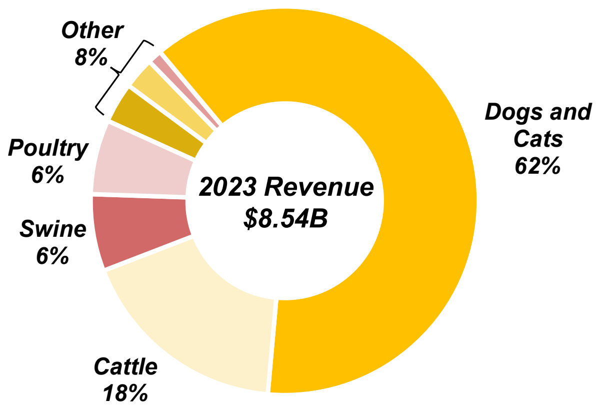
Industry Overview

The animal health care industry is dominated by few large players, including ZTS, Elanco Animal Health (NYSE: ELAN), and IDEXX Laboratories (NASDAQ: IDXX), as well as the animal health subsidiaries of Boehringer Ingelheim and Merck (NYSE: MRK). The industry benefits from significant pricing power due to its large, fragmented customer base and reduced competitive landscape. Unlike non-animal health care, where pricing is heavily regulated and consolidated, the animal health market comprises numerous, small-scale, cash-paying buyers, including individual pet owners and livestock producers. This fragmentation allows companies to implement price increases more easily than in non-animal situations. The animal health market is also experiencing significant growth, driven by the secular growth of companion animals. Since the onset of COVID-19 in 2020, there has been an increase of approximately five million pets in the U.S., with the industry projected to grow at an 8% CAGR until 2030. Similarly, due to the rise in the middle-class population, demand for livestock has increased significantly, presenting long-term opportunities for animal health companies.

Librela and Solensia Update

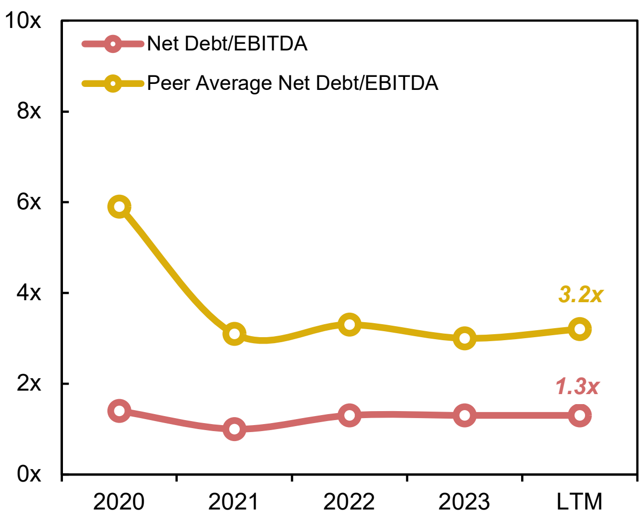
On April 12, 2024, the Wall Street Journal published an article that questioned the safety of the Company's arthritis drugs, Librela and Solensia. The article claimed these drugs were causing significant adverse reactions in dogs and cats. As a core part of ZTS's growth narrative, shares traded down 8% on the day and prompted the CPMT to reevaluate the name. Since then, these drugs have received robust support from the veterinary community. A JPM survey of vets revealed high efficacy (8.4/10) and safety (8.5/10) ratings, with Librela incidence rates in-line with typical product launches in animal health (<1%). Likewise, Barclay's reported that 88% of vets in a Q1 2024 Vet Survey continue to prescribe Librela, which suggests the concern is not around the confidence of vets in the medication, but the current noise affecting near-term Librela uptake for pet owners. However, the long-term outlook of the (cont.)

Figure 2: 2023 Species Segmentation



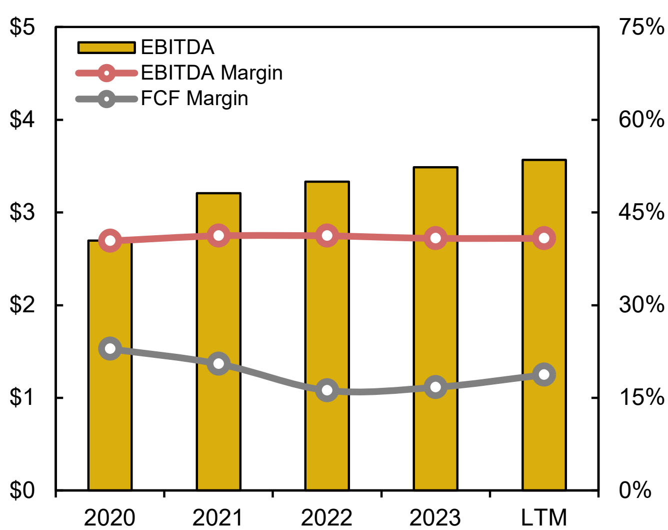
Source: Company Filings

Figure 3: Net Debt/EBITDA vs Peers



Source: S&P Capital IQ

Figure 4: LHS EBITDA (US$B) vs RHS Margin Analysis (%)



Source: S&P Capital IQ

drugs remain compelling, with few alternatives in the market. With an estimated 50-70% prescription rate in pet osteoarthritis situations, the Company maintains its trajectory to greater than US$1B in sales.

Mandate Fit

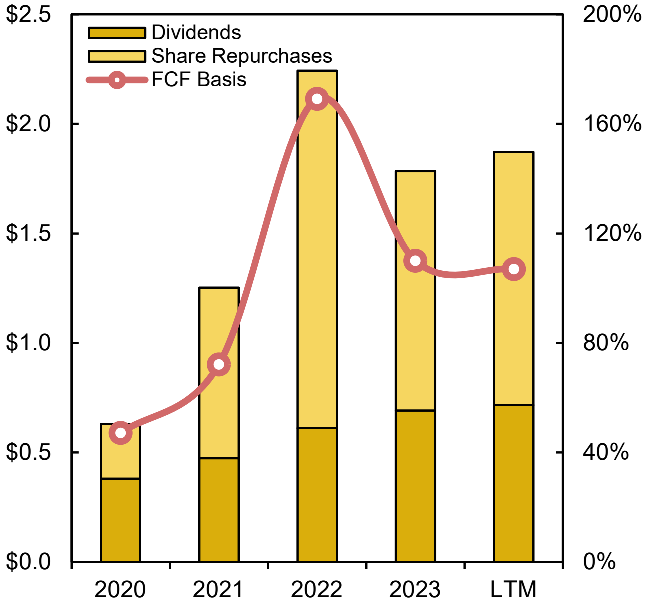
Quality Management: Kristin Peck assumed her role as CEO in 2020 after eight years with the company, during which she led ZTS through its 2013 IPO. Before joining the Company, Peck served as an Independent Director at Thomson Reuters (NYSE: TRI) and as Executive Vice President of Worldwide Business Development and Innovation at Pfizer (NYSE: PFE). In 2023, 92% of Peck's compensation was performance-based, with ~60% awarded in PSUs and RSUs. Likewise, 76% of NEO pay was considered at-risk, with 19% directly tied to revenue, EPS, and FCF results. The management team has prioritized a robust R&D platform, with equal emphasis on the prediction, prevention, detection, and treatment stages of innovation. This has allowed ZTS to introduce over 2,000 new products and lifecycle innovations over the past decade.

Competitive Advantage: ZTS's competitive advantage stems from the breadth and depth of its product lines. By species, it is ranked first in market share for companion animals, cattle, fish, and swine, which together constitute over 90% of its revenue. By geography, it ranks first in North America, Asia, and Latin America, and second in both Eastern and Western Europe. The Company's diversification in both operations and geography acts to mitigate operating risks. ZTS currently holds ~5,880 granted patents with ~1,500 patents pending, filed in over 50 countries. This allows the Company to price its products at a premium, which is further supported by the reduced impact of patent expiration in the industry. ZTS leverages its connections with more than 300 leading research institutions and universities, offering access to cutting-edge technologies and pharmaceutical targets. The Company also utilizes its direct network of 29 manufacturing sites to preserve strong operating margins relative to competitors. Lastly, ZTS continues to remain active in the acquisition market, acquiring PetMedix and Adivo in 2023 to help expand current product lines. The Company continues to seek strategic opportunities to expand its leading market position.

Strong Balance Sheet: ZTS's balance sheet possesses an LTM Net Debt/EBITDA ratio of 1.3x, an LTM Total Debt/EBITDA ratio of 1.9x, and an LTM Interest Coverage ratio of 15.6x, compared to peer averages of 3.2x, 3.5x, and 19.1x, respectively. The Company holds ~US$2.0B in cash and cash equivalents, with an additional US$1B unsecured long-term revolving credit facility. ZTS also has a US$1.1B short-term credit facility, with US$1B expiring at the end of 2024. ~40% of debt for ZTS is due post-2034, with an upcoming maturity wall worth US$1.4B in 2025. The CPMT is confident in the Company's ability to refinance due to its low leverage and superior financial position in the industry. Despite regulatory risks in animal health care resulting in lower credit ratings, ZTS holds a BBB Stable credit rating from S&P Global and a Baa1 Positive from Moody's.

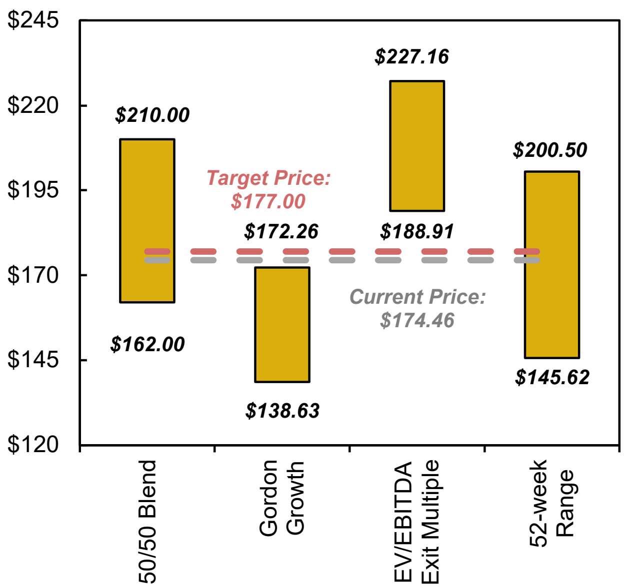
Growing Free Cash Flow: ZTS's FCF has grown at a five-year CAGR of 5.22% from 2019 to 2023. This is largely attributable to the Companion Animal segment, which has seen significant growth from the release and expansion of its Librela, Solencia, and Simparica Trio product lines. ZTS has also grown its manufacturing and distribution presence, allowing for greater control and an improved net margin over the last five years. The Company has seen an increase in SG&A expenses and encountered occasional regulatory difficulties as products are released in new geographies, which pose risks to FCF growth in the near-term.

Figure 5: Capital Returned to Shareholders (US$B)



Source: S&P Capital IQ

Figure 6: Valuation Football Field



Source: CPMT Estimates, Company Filings

Risks

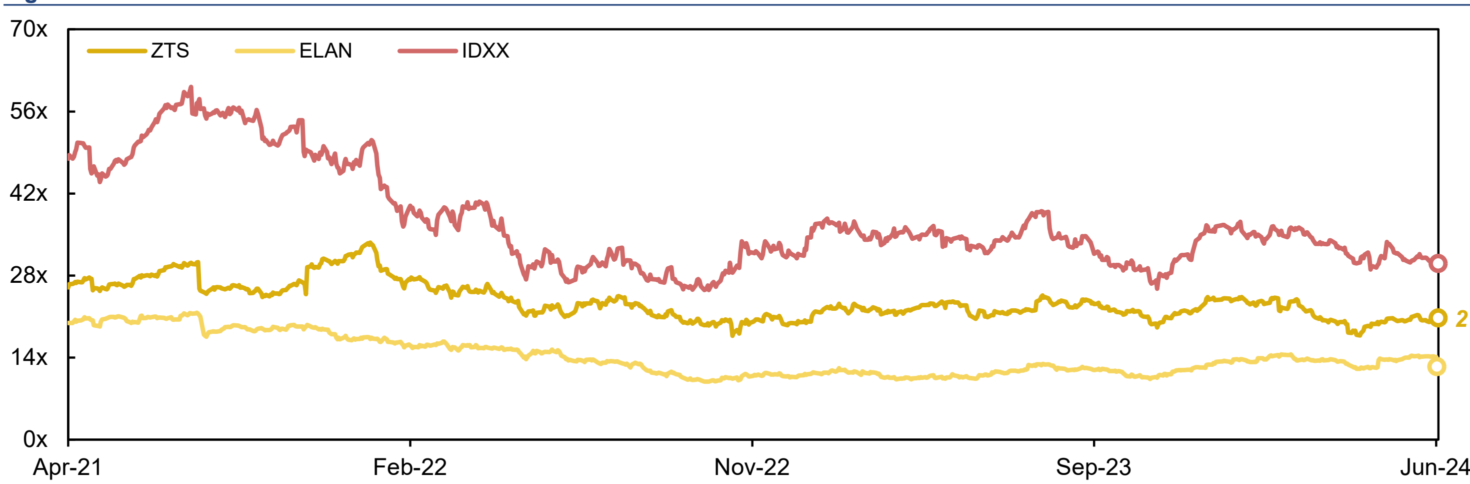
ZTS relies heavily on a global supply chain for the procurement of raw materials, manufacturing of products, and distribution to customers. The Company also depends on a network of 109 third-party contract manufacturing organizations around the world. Disruptions caused by natural disasters, geopolitical events, or logistical issues can severely affect ZTS' ability to meet demand and maintain operational efficiency. The unpredictability of animal plague also poses a risk to the Company, evidenced in 2019 during the African Swine Fever, which significantly affected international livestock segment growth. Although patent expiration is also a concern in the industry, it is lessened due to longer product lifecycles and reduced insurance coverage for animal health generics. The Company is also susceptible to foreign exchange risk, with management evaluating operations in Argentina's hyperinflationary environment, which accounts for ~3% of ZTS' overall revenue.

Investment Thesis and Valuation

The CPMT valued ZTS at US$177 using a 5-year DCF with a WACC of 7.5%. The terminal value was determined through a 50/50 blend of (1) the Gordon Growth method, using a 3.0% terminal growth rate and (2) an average of an EV/EBITDA exit multiple of 20.0x.

Since entering a position in Q4 2021, ZTS has upheld the CPMT's original investment thesis, realizing higher-than-expected companion animal growth. That said, the holding period return has since been volatile, with Q1 2024 closing relatively flat. A period of outperformance in 2023 was driven by robust sales in Companion sales, which was offset following the Librela and Solensia drug allegations. The market is currently pricing in close to a worst-case scenario for Librela uptake, a thesis which the Fund disagrees with. The consistent positive feedback from the veterinary community and lack of alternatives in the market will likely continue to sustain market relevance, despite short-term public perception challenges. The CPMT has conviction in the name as a resilient and strategic asset in the portfolio, poised for long-term growth estimated at ~7% topline CAGR through 2030, despite using conservative Librela and Solensia estimates. The Company holds a leadership position within its industry and operates a business model that can generate superior top-line growth compared to peers based on its proven execution of organic and inorganic growth. With trading multiples approaching all-time lows, the Fund recommends a hold to continue to assess the outcome of the Librela and Solensia while gaining exposure to ZTS's attractive fundamentals.

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ