Zoetis

Health Care
NYSE: ZTS
Market Perform | Hold

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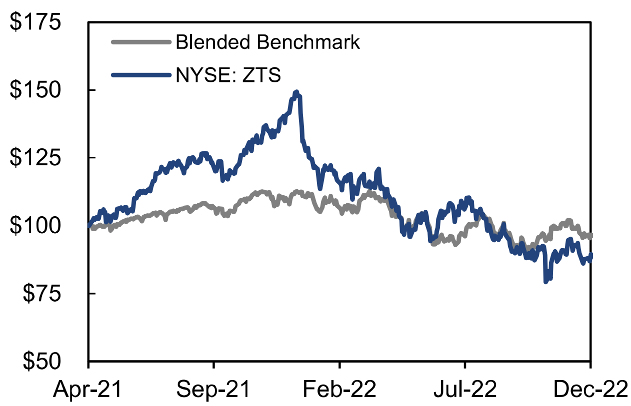
Return on Investment	
Current Share Price	$146.55
Intrinsic Value	$153.00
Dividend Yield	0.90%
Implied Discount	4%
Conviction Rating	1

Market Profile	
52-Week Range	$124.15 - $249.27
Market Capitalization (US$mm)	$66,737
Net Debt (US$mm)	$4,173
Enterprise Value (US$mm)	$70,911
Beta (5-Year Monthly)	0.63

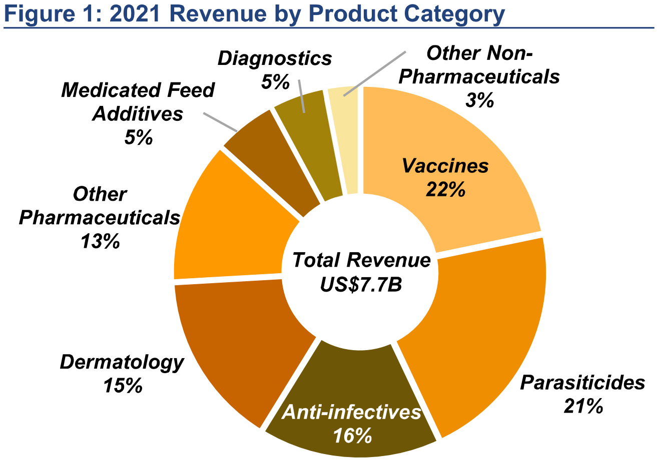
Metrics	2022E	2023E	2024E
Revenue (US$mm)	$8,112	$8,630	$9,376
EBITDA (US$mm)	$3,042	$3,279	$3,563
EPS	$5.12	$5.74	$6.41
EV/EBITDA	23.3x	21.6x	19.9x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: 2021 Revenue by Product Category



Source: Company Filings

Business Description

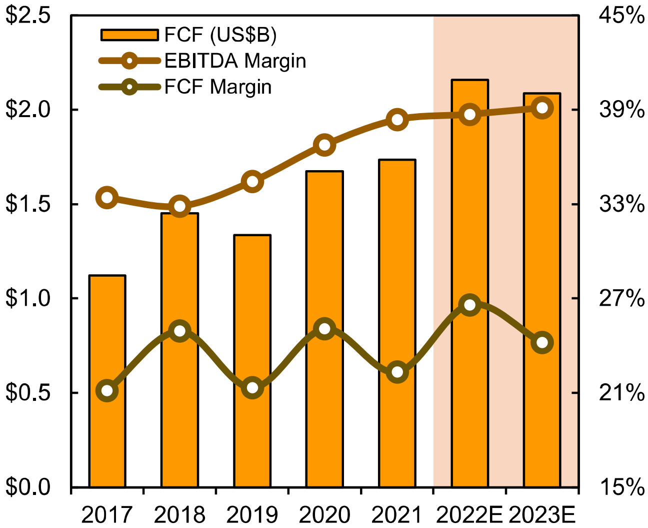
Zoetis (NYSE: ZTS) is a global leader in the animal health industry that develops, manufactures, and commercializes pharmaceutical products. ZTS' products are sold in over 100 countries across North America, South America, Europe, Asia, Africa, and Australia. The Company's diversified business operates in two main segments of animal species: (1) Companion Animals and (2) Livestock. The Companion Animal segment includes products for pets such as dogs, cats, and horses; the Livestock segment categorizes species such as cattle, swine, poultry, and fish. ZTS has ~300 product lines across seven main product categories including pharmaceutical, vaccines, parasiticides, dermatology, anti-infectives, medicated feed additives, and animal health diagnostics. ZTS' remaining revenue is accumulated from non-pharmaceutical product categories such as nutritional, agribusiness, as well as products/services in biodevices, genetics, and precision animal health.

Industry Overview

The animal healthcare industry consists of a fragmented customer base with cash-paying buyers and a high concentration of animal health firms, granting animal drugmakers substantial pricing power. This starkly contrasts human health, wherein drug manufacturers and consumers are so distant that intermediaries can aggressively negotiate on list prices. ZTS' main competitors include companies within animal health medicine, vaccines, and diagnostics industries, such as: Boehringer Ingelheim Animal Health, Merck Animal Health, Elanco Animal Health (NYSE: ELAN), and IDEXX Laboratories (NASDAQ: IDXX). Boehringer and Merck operate as animal health divisions of larger human healthcare companies, as did Abbott Laboratories (NYSE: ABT) until ZTS acquired its animal health assets in 2015. ELAN is ZTS' closest standalone competitor.

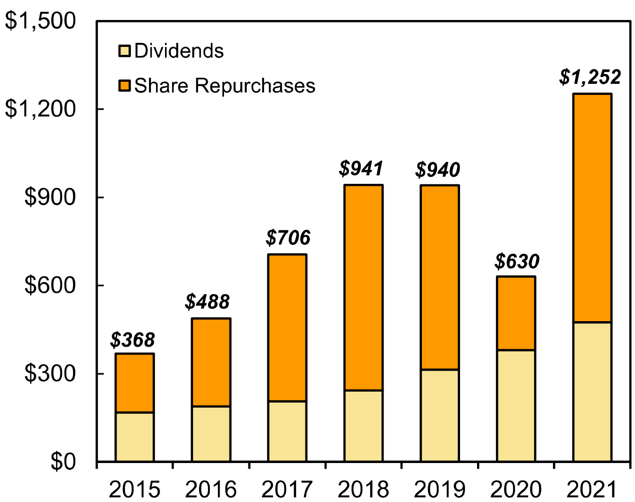
Although not as expensive and time consuming as human health, the capital and innovation intensity needed to compete in animal healthcare still create high barriers to entry. Additionally, efficient responses to the regulatory landscape is a key success factor in the industry; for example, there is growing interest in alternatives to livestock antibiotics due to its potential for human ingestion through the food chain. With an expected increased demand for livestock products alongside a growing adoption of meat-heavy diets in emerging markets, innovation remains a primary focus for guiding price-sensitive consumers away from generic alternatives. In turn, these alternatives are becoming a target for R&D spending. The advanced care resulting from this innovation has also resulted in a higher life expectancy of pets. There is skepticism about the legitimacy of pet adoption growth numbers during the pandemic, as several papers report a 45% decrease in animal shelter adoption in 2020. However, there was still a significant increase in veterinary visits in 2020 and 2021, as pet owners working from home were more diligent in identifying health concerns. The willingness to subsequently pay for care also increased, with U.S. pet owners spending ~US$70B on pet health and treatments in 2022. In 2023 to 2032, the pet healthcare market has an expected 7% CAGR due to inelastic spending for animal care. The overall trend towards a strengthening human-pet bond suggests continued increases in pet care spending, and thus a large runway for industry growth.

Figure 2: LHS FCF vs RHS Margins



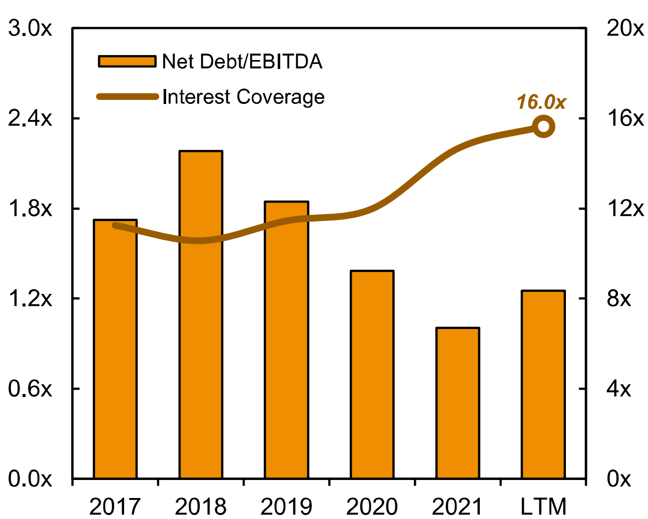
Source: S&P Capital IQ

Figure 3: Capital Returned to Shareholders (US$mm)



Source: S&P Capital IQ

Figure 4: LHS Net Debt/EBITDA vs RHS Interest Coverage



Source: S&P Capital IQ

Mandate Fit

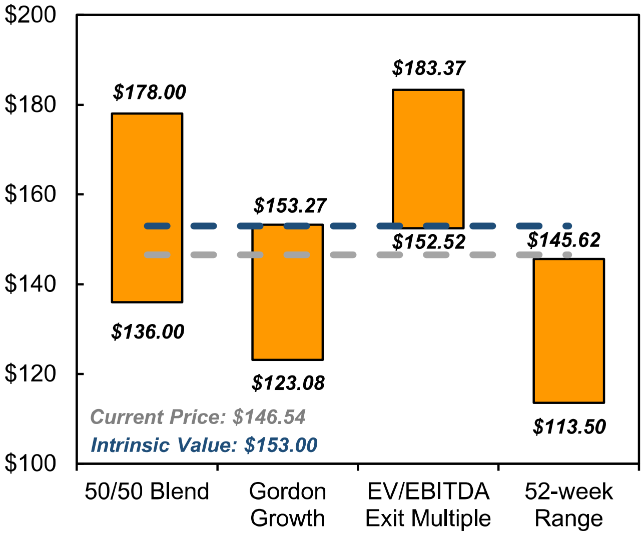
Quality Management: Kristin Peck has been with the Company since 2012 and was appointed as CEO in January 2020. Prior to this role, Peck served as Executive VP of Business Development and Strategy of U.S. Operations at ZTS. Before ZTS' initial public offering in 2012, Peck served as Executive VP of Worldwide Business Development and Innovation at Pfizer (NYSE: PFE) where she was responsible for evaluating strategic alternatives for PFE's Animal Health and Nutrition businesses. Management's capital allocation strategy consists of reinvestment into R&D and inorganic growth. The selection of acquisitions has been rigorous, as management focuses on targets with long-term growth potential that easily synergize with the Company's existing network. The CPMT points to Abaxis, ZTS' largest acquisition to date, as exemplary in this regard. Management has successfully deployed the Abaxis platform through its existing salesforce and created a single product for veterinarian customers, enhancing its already strong competitive advantage. The Fund is confident that management will continue to identify the fastest-growing subindustries of animal health (in the case Abaxis diagnostics) whose products easily tuck into ZTS' product portfolio, then pursue high-NPV acquisitions to capitalize on the opportunities.

Competitive Advantage: ZTS has the widest economic moat of all its competitors, with a presence in almost every type of animal-related health market. Unlike the Company's competitors that are embedded in larger human pharmaceutical firms, ZTS can allocate resources to products that primarily address unmet animal needs. ZTS' product portfolio possesses ~6,250 granted patents in more than 50 countries, concentrated in major markets with strong patent systems. Patent-protected products account for at least 20% of the firm's revenue, enabling quasi-monopolistic pricing power. Moreover, the Company possesses the capital required to continually invest in R&D and ensure insulation around key products from competitors. Additionally, due to its scale and direct distribution service to customers, ZTS captures superior gross margins over its competitors (e.g., a consistent ~12% advantage over ELAN).

Strong Balance Sheet: ZTS has a LTM Net Debt/EBITDA of 1.3x, significantly lower than the peer average of 3.1x. The Company holds US$2.5B in cash and equivalents, with additional liquidity available through a US$1.0B unsecured revolving credit facility. Traditionally, the regulatory risks within animal healthcare result in lower credit ratings for industry participants. ZTS holds a BBB Stable credit rating from S&P Global and a Baa1 Stable from Moody's, with upgrades pending the Company's ability to sustain a Total Debt/EBITDA below 2.5x. Currently, ZTS' LTM Total Debt/EBITDA is 2.0x with US$8.0B in Total Debt, with its capital structure consisting of only ~12% debt. The CPMT is confident in the Company's ability to pay off its maturing debt in early 2023 and late 2025 via incoming FCF and cash on hand.

Growing Free Cash Flow: ZTS has grown FCF at a five-year CAGR of ~7%. Growth has primarily been driven by companion animals, who provide larger and faster-growing revenues along with superior margins to livestock. The CPMT expects the Company's operating margin to further improve as it removes poor-performing products in its livestock segment and consolidates its manufacturing sites. However, though a substantial source of growth, the Company's expansion into emerging markets will be accompanied by lower margins, and recent supply chain troubles and regulatory hurdles with Librela are delaying anticipated growth. As such, the Fund forecasts a four-year FCF CAGR of 8%.

Figure 5: Valuation Football Field

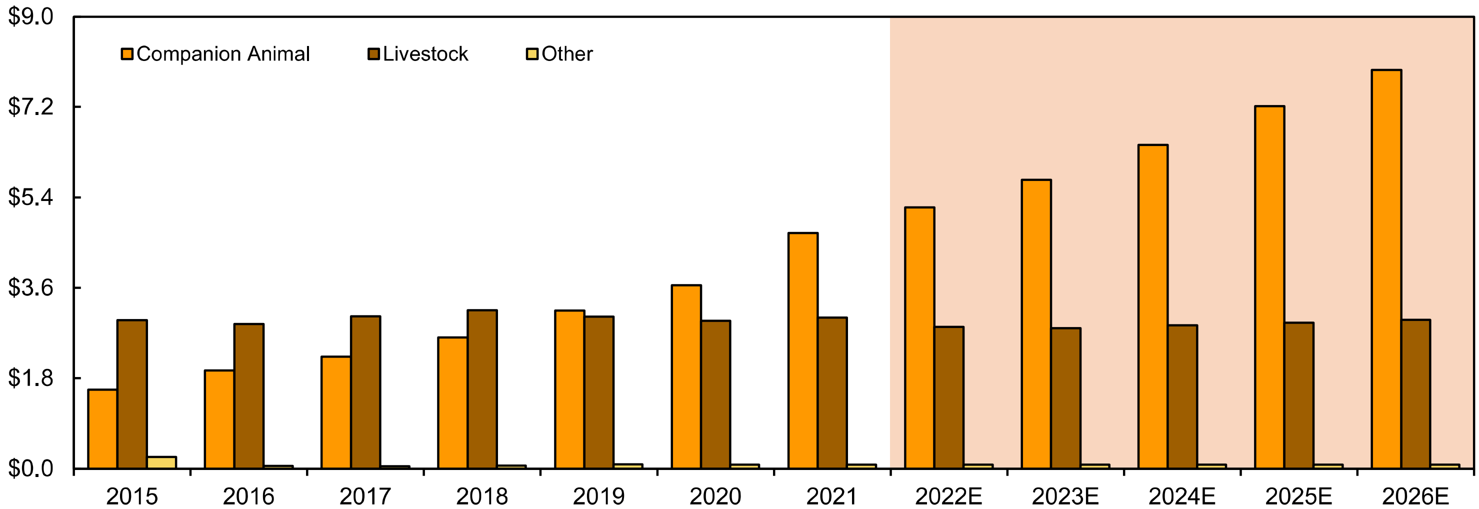


Source: CPMT Estimates

Investment Thesis and Valuation

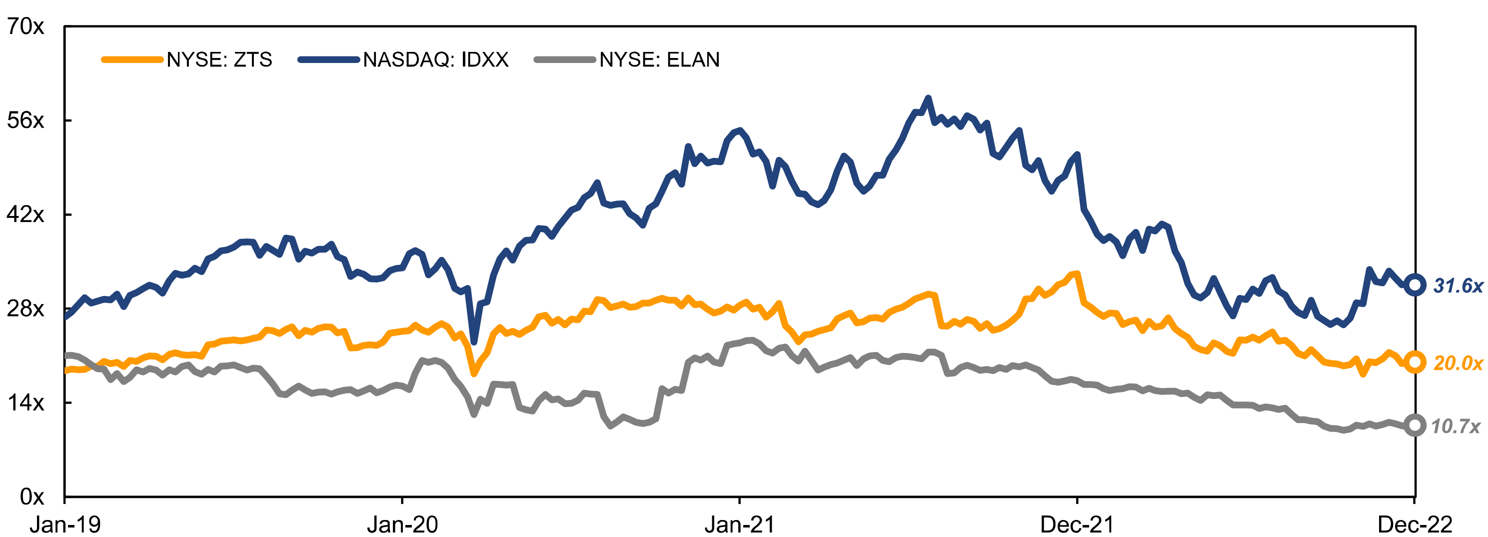
The CPMT valued ZTS using a DCF analysis with a forecast period from Q4 2022 until Q4 2026. UFCFs were discounted at a WACC of 7.3%, consisting of a 50/50 blend of (1) the Gordon Growth method using a 3.0% terminal growth rate, and (2) the application of a 20.0x EV/EBITDA exit multiple, yielding an intrinsic value of $153. Since entering a position in Q4 2021, ZTS has upheld the original investment thesis, realizing higher-than-expected companion animal growth. That said, the intrinsic value has been lowered since initially entering a position, largely due to headwinds from increased generic competition in the livestock segment, where ZTS' competitive advantage is weaker. In the bull case, livestock revenues rebound off strong international growth with margins similar to those achieved in the U.S., resulting in an intrinsic value of $189. The bear case forecasts slowed growth in companion animals and stagnation in livestock revenues, resulting in an intrinsic value of $123. As ZTS' share price has also lowered over the holding period, the new base intrinsic value still offers minor upside, and the Company has shown resilience in its ability to meet the mandate. Accordingly, the CPMT remains convicted in the name and thus recommends a hold.

Figure 6: Revenue by Segment (US$B)



Source: S&P Capital IQ

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ