

Zoetis Inc.  
Form 10-Q  
November 05, 2015  
Table of Contents

---

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the quarterly period ended September 27, 2015  
or  
 TRANSITION REPORT PURSUANT TO SECTION 13  
OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-35797

Zoetis Inc.

(Exact name of registrant as specified in its charter)

Delaware	46-0696167
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 Campus Drive, Florham Park, New Jersey	07932
(Address of principal executive offices)	(Zip Code)
(973) 822-7000	
(Registrant's telephone number, including area code)	

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act).  Yes  No

At November 2, 2015, there were 497,920,464 shares of common stock outstanding.

---



Table of Contents

TABLE OF CONTENTS

	Page
<u>PART I — FINANCIAL INFORMATION</u>	<u>1</u>
Item 1. <u>Financial Statements</u>	<u>1</u>
Condensed Consolidated Statements of Income (Unaudited)	<u>1</u>
Condensed Consolidated Statements of Comprehensive Income (Unaudited)	<u>2</u>
Condensed Consolidated (Unaudited) Balance Sheets	<u>3</u>
Condensed Consolidated Statements of Equity (Unaudited)	<u>4</u>
Condensed Consolidated Statements of Cash Flows (Unaudited)	<u>5</u>
Notes to Condensed Consolidated Financial Statements (Unaudited)	<u>6</u>
Review Report of Independent Registered Public Accounting Firm	<u>24</u>
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>25</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>48</u>
Item 4. <u>Controls and Procedures</u>	<u>48</u>
<u>PART II — OTHER INFORMATION</u>	<u>49</u>
Item 1. <u>Legal Proceedings</u>	<u>49</u>
Item 1A. <u>Risk Factors</u>	<u>49</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>52</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>52</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>52</u>
Item 5. <u>Other Information</u>	<u>52</u>
Item 6. <u>Exhibits</u>	<u>53</u>
<u>SIGNATURES</u>	<u>54</u>

Table of Contents

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

## ZOETIS INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three Months Ended		Nine Months Ended	
	September	September	September	September
	27,	28,	27,	28,
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)	2015	2014	2015	2014
Revenue	\$1,214	\$1,210	\$3,491	\$3,465
Costs and expenses:				
Cost of sales <sup>(a)</sup>	421	434	1,242	1,226
Selling, general and administrative expenses <sup>(a)</sup>	374	394	1,107	1,146
Research and development expenses <sup>(a)</sup>	91	93	255	272
Amortization of intangible assets <sup>(a)</sup>	15	16	45	46
Restructuring charges and certain acquisition-related costs	13	2	280	10
Interest expense, net of capitalized interest	29	29	86	87
Other (income)/deductions—net	(2	) 4	—	13
Income before provision for taxes on income	273	238	476	665
Provision for taxes on income	83	71	157	204
Net income before allocation to noncontrolling interests	190	167	319	461
Less: Net income attributable to noncontrolling interests	1	1	2	4
Net income attributable to Zoetis Inc.	\$189	\$166	\$317	\$457
Earnings per share attributable to Zoetis Inc. stockholders:				
Basic	\$0.38	\$0.33	\$0.63	\$0.91
Diluted	\$0.38	\$0.33	\$0.63	\$0.91
Weighted-average common shares outstanding:				
Basic	499.239	501.453	500.186	500.887
Diluted	501.653	502.445	502.480	501.610
Dividends declared per common share	\$0.083	\$0.072	\$0.166	\$0.144

Amortization expense related to finite-lived acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in

(a) Amortization of intangible assets as these intangible assets benefit multiple business functions. Amortization expense related to finite-lived acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate, in the condensed consolidated statements of income.

See notes to condensed consolidated financial statements.

Table of Contents

ZOETIS INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (UNAUDITED)

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS)				
Net income before allocation to noncontrolling interests	\$ 190	\$ 167	\$ 319	\$ 461
Other comprehensive (loss)/income, net of taxes and reclassification adjustments:				
Unrealized loss on derivatives, net	(3	) —	(3	) —
Foreign currency translation adjustments, net	(57	) (38	) (200	) (20
Benefit plans: Actuarial gains/(losses), net <sup>(a)</sup>	—	(1	) 1	(1
Plan settlement, net <sup>(b)</sup>	—	—	—	3
Total other comprehensive (loss)/income, net of tax	(60	) (39	) (202	) (18
Comprehensive income before allocation to noncontrolling interests	130	128	117	443
Less: Comprehensive (loss)/income attributable to noncontrolling interests	(2	) 2	(1	) 4
Comprehensive income attributable to Zoetis Inc.	\$ 132	\$ 126	\$ 118	\$ 439

Presented net of reclassification adjustments and tax impacts, which are not significant in any period presented.

(a) Reclassification adjustments related to benefit plans are generally reclassified, as part of net periodic pension cost, into Cost of sales, Selling, general and administrative expenses, and/or Research and development expenses, as appropriate, in the condensed consolidated statements of income.

(b) Reflects the 2014 settlement charge associated with the 2012 sale of our Netherlands manufacturing facility which was recorded to Other (income)/deductions—net. See Note 12. Benefit Plans for additional information.

See notes to condensed consolidated financial statements.

2 |

---

Table of ContentsZOETIS INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 27, 2015	December 31, 2014
(MILLIONS OF DOLLARS, EXCEPT SHARE AND PER SHARE DATA)	(Unaudited)	
Assets		
Cash and cash equivalents	\$592	\$882
Accounts receivable, less allowance for doubtful accounts of \$39 in 2015 and \$32 in 2014	1,038	980
Inventories	1,403	1,289
Current deferred tax assets	127	109
Other current assets	264	205
Assets held for sale	26	—
Total current assets	3,450	3,465
Property, plant and equipment, less accumulated depreciation of \$1,201 in 2015 and \$1,145 in 2014	1,293	1,318
Goodwill	1,163	976
Identifiable intangible assets, less accumulated amortization	679	727
Noncurrent deferred tax assets	58	54
Other noncurrent assets	43	48
Total assets	\$6,686	\$6,588
Liabilities and Equity		
Short-term borrowings	\$8	\$7
Current portion of long-term debt	400	—
Accounts payable	306	290
Dividends payable	—	42
Accrued expenses	599	475
Accrued compensation and related items	197	238
Income taxes payable	91	26
Other current liabilities	57	8
Total current liabilities	1,658	1,086
Long-term debt	3,226	3,624
Noncurrent deferred tax liabilities	227	277
Other taxes payable	63	57
Other noncurrent liabilities	258	207
Total liabilities	5,432	5,251
Commitments and contingencies		
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; 501,573,533 and 501,342,267 shares issued; 498,333,086 and 501,327,524 shares outstanding at September 27, 2015, and December 31, 2014, respectively	5	5
Treasury stock, at cost, 3,240,447 and 14,743 shares of common stock at September 27, 2015, and December 31, 2014, respectively	(150)	) —
Additional paid-in capital	993	958

Edgar Filing: Zoetis Inc. - Form 10-Q

Retained earnings	943	709
Accumulated other comprehensive loss	(562	) (361
Total Zoetis Inc. equity	1,229	1,311
Equity attributable to noncontrolling interests	25	26
Total equity	1,254	1,337
Total liabilities and equity	\$6,686	\$6,588

See notes to condensed consolidated financial statements.

3 |

---

Table of Contents

ZOETIS INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF EQUITY  
(UNAUDITED)

(MILLIONS OF DOLLARS)	Zoetis				Accumulated Other Comprehensive Loss	Equity Attributable to Noncontrolling Interests	Total Equity
	Common Stock <sup>(a)</sup>	Treasury Stock <sup>(a)</sup>	Paid-in Capital	Retained Earnings			
Balance, December 31, 2013	\$5	\$—	\$ 878	\$276	\$ (219 )	\$ 22	\$962
Nine months ended September 28, 2014							
Net income	—	—	—	457	—	4	461
Other comprehensive income/(loss)	—	—	—	—	(18 )	—	(18 )
Share-based compensation awards <sup>(b)</sup>	—	—	23	—	—	—	23
Defined contribution plans transactions <sup>(c)</sup>	—	—	32	—	—	—	32
Pension plan transfer from Pfizer Inc. <sup>(d)</sup>	—	—	3	—	(3 )	—	—
Employee benefit plan contribution from Pfizer Inc. <sup>(e)</sup>	—	—	2	—	—	—	2
Dividends declared	—	—	—	(72 )	—	(1 )	(73 )
Balance, September 28, 2014	\$5	\$—	\$ 938	\$661	\$ (240 )	\$ 25	\$1,389
Balance, December 31, 2014	\$5	\$—	\$ 958	\$709	\$ (361 )	\$ 26	\$1,337
Nine months ended September 27, 2015							
Net income	—	—	—	317	—	2	319
Other comprehensive income/(loss)	—	—	—	—	(201 )	(1 )	(202 )
Share-based compensation awards <sup>(b)</sup>	—	(2 )	33	—	—	—	31
Treasury stock acquired <sup>(f)</sup>	—	(148 )	—	—	—	—	(148 )
Employee benefit plan contribution from Pfizer Inc. <sup>(e)</sup>	—	—	2	—	—	—	2
Dividends declared	—	—	—	(83 )	—	(2 )	(85 )
Balance, September 27, 2015	\$5	\$(150 )	\$ 993	\$943	\$ (562 )	\$ 25	\$1,254

As of September 27, 2015, and September 28, 2014, there were 498,333,086 and 501,195,696 outstanding shares <sup>(a)</sup> of common stock, respectively, and 3,240,447 and 13,792 shares of treasury stock, respectively. Treasury stock is recognized at the cost to reacquire the shares. For additional information, see Note 14. Stockholders' Equity.

Includes the issuance of shares of Zoetis Inc. common stock and the reacquisition of shares of treasury stock <sup>(b)</sup> associated with the vesting of employee share-based awards. For additional information, see Note 13. Share-Based Payments and Note. 14. Stockholders' Equity.

<sup>(c)</sup> Reflects company matching and profit-sharing contributions funded through the issuance of shares of Zoetis Inc. common stock. For additional information, see Note 14. Stockholders' Equity.

<sup>(d)</sup> Reflects the 2014 transfers of defined benefit pension plans from Pfizer Inc. and the associated reclassification from Additional Paid in Capital to Accumulated Other Comprehensive Loss. See Note 12. Benefit Plans.

<sup>(e)</sup>



Edgar Filing: Zoetis Inc. - Form 10-Q

Represents contributed capital from Pfizer Inc. associated with service credit continuation for certain Zoetis Inc. employees in Pfizer Inc.'s U.S. qualified defined benefit and U.S. retiree medical plans. See Note 12. Benefit Plans.

<sup>(f)</sup> Reflects the acquisition of treasury shares in connection with the Share Repurchase Program. For additional information, see Note 14. Stockholders' Equity.

See notes to condensed consolidated financial statements.

4 |

---

Table of Contents

ZOETIS INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)

	Nine Months Ended	
	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS)		
Operating Activities		
Net income before allocation to noncontrolling interests	\$319	\$461
Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization expense	144	151
Share-based compensation expense	31	22
Restructuring, net of payments	207	—
Asset write-offs and asset impairments	48	8
Deferred taxes	(81)	(60)
Employee benefit plan contribution from Pfizer Inc.	2	2
Other non-cash adjustments	11	(8)
Other changes in assets and liabilities, net of acquisitions and divestitures		
Accounts receivable	(150)	) 39
Inventories	(142)	) (107)
Other assets	(64)	) 1
Accounts payable	30	(237)
Other liabilities	(37)	) (79)
Other tax accounts, net	68	46
Net cash provided by operating activities	386	239
Investing Activities		
Purchases of property, plant and equipment	(143)	) (129)
Milestone payment related to previously acquired intangibles	—	(15)
Asset acquisition <sup>(a)</sup>	(229)	) —
Net proceeds from sales of assets	2	8
Other investing activities	(8)	) (1)
Net cash used in investing activities	(378)	) (137)
Financing Activities		
Increase (decrease) in short-term borrowings, net	2	(5)
Stock-based compensation-related proceeds and excess tax benefits	4	2
Purchases of treasury stock	(150)	) —
Cash dividends paid	(127)	) (109)
Net cash used in financing activities	(271)	) (112)
Effect of exchange-rate changes on cash and cash equivalents	(27)	) (2)
Net decrease in cash and cash equivalents	(290)	) (12)
Cash and cash equivalents at beginning of period	882	610
Cash and cash equivalents at end of period	\$592	\$598
Supplemental cash flow information		
Cash paid during the period for:		
Income taxes	\$175	\$210
Interest, net of capitalized interest	117	117

Non-cash transactions:

Intangible asset acquisition <sup>(b)</sup>	\$—	\$8
Purchases of property, plant and equipment	12	—
Contingent purchase price consideration <sup>(a)</sup>	22	—

(a) Reflects the acquisition of certain assets of Abbott Animal Health. See Note 5. Acquisitions and Divestitures for additional information.

(b) Reflects the non-cash portion of the acquisition of product registration and application rights from Pfizer in the third quarter of 2014.

See notes to condensed consolidated financial statements.

5 |

---

Table of Contents

ZOETIS INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Organization

Zoetis Inc. (including its subsidiaries, collectively, Zoetis, the company, we, us or our) is a global leader in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on both livestock and companion animals. We organize and operate our business in two geographic regions: the United States (U.S.) and International.

We directly market our products in approximately 70 countries across North America, Europe, Africa, Asia, Australia and South America. Our products are sold in more than 120 countries, including developed markets and emerging markets, and our revenue is mostly generated in the United States. We have a diversified business, marketing products across eight core species: cattle, swine, poultry, sheep and fish (collectively, livestock) and dogs, cats and horses (collectively, companion animals); and within five major product categories: anti-infectives, vaccines, parasiticides, medicated feed additives and other pharmaceuticals.

2. The Separation and Transactions and Agreements with Pfizer

Pfizer Inc. (Pfizer) formed Zoetis to acquire, own and operate the animal health business of Pfizer. On June 24, 2013, Pfizer completed an exchange offer (the Exchange Offer) resulting in the full separation of Zoetis from Pfizer and the disposal of Pfizer's entire ownership and voting interest in Zoetis.

In the first quarter of 2013, through a series of steps (collectively, the Separation), Pfizer transferred to us its subsidiaries holding substantially all of the assets and liabilities of its animal health business. After the Separation, an initial public offering (IPO) of our common stock was completed. Pfizer retained the net proceeds from the IPO.

Zoetis had related party transactions with Pfizer through the completion of the Exchange Offer. As of the completion of the Exchange Offer, Pfizer is no longer a related party. In connection with the IPO, we entered into certain agreements that provide a framework for an ongoing relationship with Pfizer. For additional information regarding activities while Pfizer was a related party, as well as our ongoing agreements with Pfizer, see Note 19. Transactions and Agreements with Pfizer in our 2014 Annual Report on Form 10-K.

At September 27, 2015, and December 31, 2014, \$19 million and \$24 million, respectively, was included in Accounts receivable as receivable from Pfizer, and \$35 million and \$42 million, respectively, was included in Accounts payable as payable to Pfizer.

3. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements were prepared following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (U.S. GAAP) can be condensed or omitted. Balance sheet amounts and operating results for subsidiaries operating outside the United States are as of and for the three and nine-month periods ended August 23, 2015, and August 24, 2014.

Revenue, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be representative of those for the full year.

We are responsible for the unaudited condensed consolidated financial statements included in this Form 10-Q. The condensed consolidated financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results. The information included in this interim report should be read in conjunction with the financial statements and accompanying notes included in our 2014 Annual Report on Form 10-K.

In the second quarter of 2015, we changed our segment reporting structure and recategorized certain costs that are not allocated to our operating segments. The prior period presentation has been revised to reflect the new segment reporting structure. See Note 17. Segment and Other Revenue Information for additional information.

Certain reclassifications have been made to prior year data to conform to current year presentation.

4. Significant Accounting Policies

New Accounting Standards

In September 2015, the Financial Accounting Standards Board (FASB) issued an accounting standards update to simplify the accounting for measurement period adjustments recorded during the one-year period following a business combination. The update removes the requirement for an acquirer in a business combination to account for measurement period adjustments retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which the amount of the adjustment is determined. The provisions of the new standard are effective beginning January 1, 2016, for annual and interim periods. The guidance will be adopted prospectively and early adoption is permitted. We are currently assessing whether or not to early adopt this guidance.

Table of Contents

In July 2015, the FASB issued an accounting standards update to simplify the measurement of inventory by requiring that inventory be measured at the lower of cost or net realizable value, rather than at the lower of cost or market, with market being defined as either replacement cost, net realizable value or net realizable value less a normal profit margin. The provisions of the new standard are effective beginning January 1, 2017, for annual and interim reporting periods. The guidance will be adopted prospectively and early adoption is permitted. We are currently assessing the potential impact that the adoption of this guidance will have on our consolidated financial statements, as well as whether or not to early adopt this guidance.

In April 2015, the FASB issued an accounting standards update that requires that debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, rather than as a deferred charge (i.e., an asset). Debt issuance costs associated with line-of-credit arrangements may continue to be recognized as a deferred charge. We have elected to adopt this new guidance, effective for the period ended September 27, 2015. As such, debt issuance costs, associated with Zoetis senior notes of approximately \$17 million and \$19 million as of September 27, 2015 and December 31, 2014, respectively, previously recorded within Other noncurrent assets are now presented as a direct deduction from the carrying amount of the related debt liability.

In February 2015, the FASB issued an accounting standards update that provides revised guidance on whether to consolidate certain legal entities, such as limited partnerships, limited liability corporations and securitization structures. We plan to adopt this guidance as of January 1, 2016, the required effective date, and do not expect this guidance to have a significant impact on our consolidated financial statements.

In May 2014, the FASB issued an accounting standards update that outlines a new, single comprehensive model for companies to use in accounting for revenue arising from contracts with customers. This update supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance includes a five-step model for determining how, when and how much revenue should be recognized. This update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB issued a one year deferral of the effective date. The provisions of the new standard are now effective for Zoetis beginning January 1, 2018, for annual and interim reporting periods. Early adoption is permitted beginning on January 1, 2017. The new standard allows for either full retrospective or modified retrospective transition upon adoption. We continue to assess the transition method we will elect for adoption as well as the potential impact that adopting this new guidance will have on our consolidated financial statements.

5. Acquisitions and Divestitures

Acquisition of Abbott Animal Health

On February 10, 2015, we completed the purchase of certain assets of Abbott Animal Health (AAH), a subsidiary of Abbott Laboratories (Abbott). AAH is a companion animal health business focused on the veterinary surgical suite. The purchase expands our companion animal product portfolio to include veterinarian solutions for anesthesia, pain management, and the diagnosis of diabetes.

The \$254 million purchase price included net cash of \$229 million and an additional contingent payment of \$25 million which is due to Abbott within one year of the acquisition date, subject to certain deductions in the event of sales disruptions due to supply issues. The range of undiscounted amounts that Zoetis could pay pursuant to this contingent consideration arrangement is between zero and \$25 million, with an acquisition date fair value of \$22 million. The fair value of the contingent consideration recognized as of the acquisition date was determined using a probability weighted discounted cash flow analysis that considered significant estimates and assumptions not available in the market (Level 3 inputs).

The transaction was accounted for as a business combination, with the net assets acquired measured at their respective acquisition date fair values. Preliminary amounts recorded for the acquisition include \$13 million of inventory, \$8 million of in-process research and development (IPR&D) associated with oncology and osteoarthritis projects, \$4 million of trade names related to diabetes and pain management products, \$11 million of developed technology assets

associated with pain management and surgical products, \$15 million of other intangible assets including a favorable supply agreement and product exclusivity rights and property, plant and equipment of less than \$1 million. Trade names and developed technology assets will be amortized over 15 years while other intangible assets acquired have a weighted average useful life of 5 years.

Goodwill of \$200 million, representing the excess of consideration transferred over the fair value of assets acquired, was allocated to our reportable segments and is predominantly attributable to synergies expected to be realized through the integration of AAH operations into the existing Zoetis business. The goodwill recorded is expected to be deductible for tax purposes.

All amounts recorded are subject to final valuation, however any difference between such amounts and the final fair value determination for net assets acquired is not expected to be material to our condensed consolidated financial statements.

Acquisition-related costs of the transaction were expensed as incurred and are not material to our condensed consolidated statements of income. AAH revenue and earnings occurring subsequent to the acquisition date have been included in our 2015 financial results but are not material to the condensed consolidated statements of income.

#### Assets Held for Sale

On May 5, 2015, in conjunction with the announcement of our comprehensive operational efficiency program, we announced our intent to sell or exit ten manufacturing sites over the long term. For additional information, see Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives. During the third quarter of 2015, we met the criteria for held for sale

Table of Contents

classification for two of our U.S. manufacturing sites. As of September 27, 2015, we recorded assets held for sale of \$26 million, comprising inventory (\$19 million), property, plant and equipment (\$5 million) and goodwill (\$2 million). We expect to finalize the sale of these sites within one year.

6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives  
In connection with our cost-reduction/productivity initiatives, we typically incur costs and charges associated with site closings and other facility rationalization actions, workforce reductions and the expansion of shared services, including the development of global systems. In connection with our acquisition activity, we typically incur costs and charges associated with executing the transactions, integrating the acquired operations, which may include expenditures for consulting and the integration of systems and processes, product transfers and restructuring the consolidated company, which may include charges related to employees, assets and activities that will not continue in the consolidated company. All operating functions can be impacted by these actions, including sales and marketing, manufacturing and research and development (R&D), as well as functions such as business technology, shared services and corporate operations.

On May 5, 2015, we announced a comprehensive operational efficiency program, which is incremental to the supply network strategy that was previously announced. These program's actions are focused on reducing complexity in our product portfolios through the elimination of approximately 5,000 product stock keeping units (SKUs), changing our selling approach in certain markets and reducing our presence in certain countries, as well as planning to sell or exit ten manufacturing sites over the long term. We also plan to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing commercial activities and operating more efficiently as a result of less internal complexity and more standardization of processes. As part of these initiatives, we expect to reduce certain positions through divestitures, normal attrition and involuntary terminations by approximately 2,000 to 2,500, subject to consultations with works councils and unions in certain countries, primarily over the next 15 months. As a result of our operational efficiency initiative, we recorded restructuring charges of \$8 million related to asset impairments during the three months ended September 27, 2015, and recorded restructuring charges of \$261 million related to employee termination costs (\$228 million) and asset impairments (\$33 million) during the nine months ended September 27, 2015.

As a result of our supply network strategy, we recorded restructuring charges of \$10 million related to employee termination costs (\$9 million) and asset impairments (\$1 million) during the nine months ended September 27, 2015. During the three and nine months ended September 28, 2014, we recorded restructuring charges of \$1 million and \$6 million, respectively, related to employee termination costs in Europe as a result of initiatives to reduce costs and better align our organizational structure.

The components of costs incurred in connection with restructuring initiatives, acquisitions and cost-reduction/productivity initiatives follow:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Restructuring charges and certain acquisition-related costs:				
Integration costs <sup>(a)</sup>	\$5	\$1	\$9	\$5
Restructuring charges <sup>(b)</sup> :				
Employee termination costs	—	1	237	4
Accelerated depreciation	—	—	—	1
Asset impairment charges	8	—	34	—
Total Restructuring charges and certain acquisition-related costs	13	2	280	10
Other costs associated with cost-reduction/productivity initiatives:				
Other operational efficiency initiative charges <sup>(c)</sup>	13	—	33	—



Edgar Filing: Zoetis Inc. - Form 10-Q

Other supply network strategy charges <sup>(d)</sup>	3	—	13	—
Total costs associated with acquisitions and cost-reduction/productivity initiatives	\$29	\$2	\$326	\$10

(a) Integration costs represent external, incremental costs directly related to integrating acquired businesses and primarily include expenditures for consulting and the integration of systems and processes, as well as product transfer costs.

(b) The restructuring charges for the three and nine months ended September 27, 2015, represent charges related to our operational efficiency initiative and supply network strategy. The restructuring charges for the three and nine months ended September 28, 2014, include employee termination costs in Europe (\$1 million and \$6 million, respectively). Additionally, the nine months ended September 28, 2014, includes a reversal of a previously established reserve as a result of a change in estimate of severance costs (\$2 million benefit), and accelerated depreciation related to the exiting of a research facility (\$1 million).

The restructuring charges are associated with the following:

• For the three months ended September 27, 2015—U.S. (\$3 million benefit), International (\$2 million) and Manufacturing/research/corporate (\$9 million).

• For the nine months ended September 27, 2015—U.S. (\$27 million), International (\$117 million), and Manufacturing/research/corporate (\$127 million).

• For the three months ended September 28, 2014—International (\$1 million).

Table of Contents

•For the nine months ended September 28, 2014—International (\$6 million) and Manufacturing/research/corporate (\$1 million benefit).

Represents inventory write-offs of \$5 million for the three and nine months ended September 27, 2015, included in

(c) Cost of Sales, and consulting fees of \$8 million and \$28 million for the three and nine months ended September 27, 2015, respectively, included in Selling, general and administrative expenses.

(d) Primarily represents consulting fees and is included in Cost of sales.

The components of, and changes in, our restructuring accruals follow:

(MILLIONS OF DOLLARS)	Employee Termination Costs	Asset Impairment Charges	Exit Costs	Accrual
Balance, December 31, 2014 <sup>(a)</sup>	\$ 18	\$—	\$ 1	\$ 19
Provision	237	34	—	271
Utilization and other <sup>(b)</sup>	(30	) (34	) —	(64
Balance, September 27, 2015 <sup>(a)</sup>	\$ 225	\$—	\$ 1	\$ 226

(a) At September 27, 2015, and December 31, 2014, included in Accrued expenses (\$157 million and \$13 million, respectively) and Other noncurrent liabilities (\$69 million and \$6 million, respectively).

(b) Includes adjustments for foreign currency translation.

#### 7. Other (Income)/Deductions—Net

The components of Other (income)/deductions—net follow:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Royalty-related income	\$(5	) \$(7	) \$(19	) \$(21
Identifiable intangible asset impairment charges <sup>(a)</sup>	—	6	2	6
Net gain on sale of assets <sup>(b)</sup>	—	—	—	(6
Certain legal and other matters, net <sup>(c)</sup>	—	(1	) —	10
Foreign currency loss <sup>(d)</sup>	6	7	18	23
Other, net <sup>(e)</sup>	(3	) (1	) (1	) 1
Other (income)/deductions—net	\$(2	) \$4	\$—	\$ 13

For the nine months ended September 27, 2015, represents an impairment of IPR&D assets related to the termination of a canine oncology project. For the three and nine months ended September 28, 2014, represents an

(a) impairment of IPR&D assets related to a pharmaceutical product for dogs acquired with the Fort Dodge Animal Health (FDAH) acquisition in 2009, as a result of the termination of the development program due to a re-assessment of economic viability.

(b) For the nine months ended September 28, 2014, represents the net gain on sale of land by our Taiwan joint venture.

(c) For the nine months ended September 28, 2014, represents a \$13 million charge related to a commercial settlement in Mexico, partially offset by the insurance recovery of \$1 million. See Note 16. Commitments and Contingencies for additional information. The nine months ended September 28, 2014, also includes a \$2 million insurance recovery of other litigation related charges.

(d) Primarily driven by costs related to hedging and exposures to certain emerging market currencies. The nine months ended September 28, 2014, also includes losses related to the depreciation of the Argentine peso in the first quarter of 2014.

(e) For the three months ended September 27, 2015, primarily represents interest income and other miscellaneous income. For the nine months ended September 27, 2015, primarily represents inventory losses of \$3 million sustained as a result of weather damage at storage facilities in Brazil and Australia, partially offset by interest income and other miscellaneous income. For the nine months ended September 28, 2014, represents a pension plan settlement charge related to the sale of a manufacturing plant, partially offset by interest income and other miscellaneous income.

8. Income Taxes

A. Taxes on Income

The effective tax rate was 30.4% for the third quarter of 2015, compared with 29.8% for the third quarter of 2014. The higher effective tax rate for the third quarter of 2015 was primarily attributable to changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings (i) from operations and (ii) from restructuring charges related to the operational efficiency initiative and supply network strategy, as well as repatriation costs.

The effective tax rate was 33.0% for the nine months ended September 27, 2015, compared with 30.7% for the nine months ended September 28, 2014. The higher effective tax rate for the nine months ended September 27, 2015, was primarily attributable to:

changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from (i) operations and (ii) restructuring charges related to the operational efficiency initiative and supply network strategy, as well as repatriation costs; and

a valuation allowance of \$3 million recorded in the second quarter of 2015;

partially offset by:

## Table of Contents

a \$9 million discrete tax benefit recorded in the first quarter of 2015 related to a revaluation of deferred taxes as a result of a change in tax rates; and

a \$6 million discrete tax benefit recorded in the second quarter of 2015 related to prior period tax adjustments.

### B. Deferred Taxes

As of September 27, 2015, the total net deferred income tax liability of \$48 million is included in Current deferred tax assets (\$127 million), Noncurrent deferred tax assets (\$58 million), Accrued expenses (\$6 million) and Noncurrent deferred tax liabilities (\$227 million).

As of December 31, 2014, the total net deferred income tax liability of \$125 million is included in Current deferred tax assets (\$109 million), Noncurrent deferred tax assets (\$54 million), Accrued expenses (\$11 million) and Noncurrent deferred tax liabilities (\$277 million).

### C. Tax Contingencies

As of September 27, 2015, the tax liabilities associated with uncertain tax positions of \$60 million (exclusive of interest and penalties related to uncertain tax positions of \$8 million) are included in Noncurrent deferred tax assets (\$6 million) and Other taxes payable (\$54 million).

As of December 31, 2014, the tax liabilities associated with uncertain tax positions of \$54 million (exclusive of interest and penalties related to uncertain tax positions of \$8 million) are included in Noncurrent deferred tax assets (\$6 million) and Other taxes payable (\$48 million).

Our tax liabilities for uncertain tax positions relate primarily to issues common among multinational corporations. Any settlements or statute of limitations expirations could result in a significant decrease in our uncertain tax positions. Substantially all of these unrecognized tax benefits, if recognized, would impact our effective income tax rate. We do not expect that within the next twelve months any of our uncertain tax positions could significantly decrease as a result of settlements with taxing authorities or the expiration of the statutes of limitations. Our assessments are based on estimates and assumptions that have been deemed reasonable by management, but our estimates of uncertain tax positions and potential tax benefits may not be representative of actual outcomes, and any variation from such estimates could materially affect our financial statements in the period of settlement or when the statutes of limitations expire, as we treat these events as discrete items in the period of resolution. Finalizing audits with the relevant taxing authorities can include formal administrative and legal proceedings, and, as a result, it is difficult to estimate the timing and range of possible changes related to our uncertain tax positions, and such changes could be significant.

## 9. Financial Instruments

### A. Debt

#### Credit Facilities

In December 2012, we entered into a revolving credit agreement with a syndicate of banks providing for a five-year \$1.0 billion senior unsecured revolving credit facility (the credit facility), which became effective in February 2013 upon the completion of the IPO and expires in December 2017. Subject to certain conditions, we have the right to increase the credit facility to up to \$1.5 billion. The credit facility contains a financial covenant requiring us to not exceed a maximum total leverage ratio (the ratio of consolidated net debt as of the end of the period to consolidated Earnings Before Interest, Income Taxes, Depreciation and Amortization (EBITDA) for such period) of 3.50:1 for fiscal year 2015 and 3.00:1 thereafter. The credit facility also contains a financial covenant requiring that we maintain a minimum interest coverage ratio (the ratio of EBITDA at the end of the period to interest expense for such period) of 3.50:1. In addition, the credit facility contains other customary covenants. We were in compliance with all financial covenants as of September 27, 2015, and December 31, 2014. There were no amounts drawn under the credit facility as of September 27, 2015, or December 31, 2014.

We have additional lines of credit and other credit arrangements with a group of banks and other financial intermediaries for general corporate purposes. We maintain cash and cash equivalent balances in excess of our outstanding short-term borrowings. As of September 27, 2015, we had access to \$79 million of lines of credit which expire at various times through 2017. Short-term borrowings outstanding related to these facilities were \$8 million and \$7 million as of September 27, 2015, and December 31, 2014, respectively. Long-term borrowings outstanding related to these facilities were \$2 million and \$3 million as of September 27, 2015, and December 31, 2014, respectively.

**Commercial Paper Program**

In February 2013, we entered into a commercial paper program with a capacity of up to \$1.0 billion. As of September 27, 2015, and December 31, 2014, there was no commercial paper issued under this program.

**Short-Term Borrowings**

As of September 27, 2015, short-term borrowings outstanding related to credit facilities were \$8 million, with a weighted-average interest rate of 6.0%. As of December 31, 2014, short-term borrowings outstanding related to credit facilities were \$7 million, with a weighted-average interest rate of 9.7%. See Credit Facilities for additional information.

**Senior Notes Offering and Other Long-Term Debt**

On January 28, 2013, we issued \$3.65 billion aggregate principal amount of our senior notes (the senior notes offering) in a private placement, with an original issue discount of \$10 million. The senior notes are comprised of \$400 million aggregate principal amount of our 1.150% senior notes due 2016, \$750 million aggregate principal amount of our 1.875% senior notes due 2018, \$1.35 billion aggregate principal amount of our 3.250% senior notes due 2023 and \$1.15 billion aggregate principal amount of our 4.700% senior notes due 2043.

The current portion of long-term debt was \$400 million as of September 27, 2015, with a weighted-average interest rate of 1.150%. There was no current portion of long-term debt as of December 31, 2014.

Table of Contents

The senior notes are governed by an indenture and supplemental indenture (collectively, the indenture) between us and Deutsche Bank Trust Company Americas, as trustee. The indenture contains certain covenants, including limitations on our, and certain of our subsidiaries', ability to incur liens or engage in sale-leaseback transactions. The indenture also contains restrictions on our ability to consolidate, merge or sell substantially all of our assets. In addition, the indenture contains other customary terms, including certain events of default, upon the occurrence of which the senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the senior notes, in whole or in part, at any time by paying a "make whole" premium, plus accrued and unpaid interest to, but excluding, the date of redemption. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2023 notes pursuant to this optional redemption provision, except under limited circumstances. Upon the occurrence of a change of control of us and a downgrade of the senior notes below an investment grade rating by each of Moody's Investors Service, Inc. and Standard & Poor's Ratings Services, we are, in certain circumstances, required to make an offer to repurchase all of the outstanding senior notes at a price equal to 101% of the aggregate principal amount of the senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

The components of our long-term debt follow:

	September 27, 2015	December 31, 2014
(MILLIONS OF DOLLARS)		
Lines of credit, due 2016-2018	\$2	\$3
1.150% Senior Notes due 2016	400	400
1.875% Senior Notes due 2018	750	750
3.250% Senior Notes due 2023	1,350	1,350
4.700% Senior Notes due 2043	1,150	1,150
	3,652	3,653
Unamortized debt discount / debt issuance costs	(26	) (29
Less current portion of long-term debt	(400	) —
Long-term debt	\$3,226	\$3,624

The fair value of our long-term debt, including the current portion of long-term debt, was \$3,465 million and \$3,690 million as of September 27, 2015, and December 31, 2014, respectively, and has been determined using a third-party matrix-pricing model that uses significant inputs derived from, or corroborated by, observable market data and Zoetis' credit rating (Level 2 inputs).

The principal amount of long-term debt outstanding, including the current portion of long-term debt, as of September 27, 2015, matures in the following years:

(MILLIONS OF DOLLARS)	2016	2017	2018	2019	2020	After 2020	Total
Maturities	\$401	\$—	\$751	\$—	\$—	\$2,500	\$3,652

**Interest Expense**

Interest expense, net of capitalized interest, was \$29 million and \$86 million for the three and nine months ended September 27, 2015, respectively, and \$29 million and \$87 million for the three and nine months ended September 28, 2014, respectively. Capitalized interest was \$1 million and \$3 million for the both the three and nine months ended September 27, 2015, and September 28, 2014, respectively.

**B. Derivative Financial Instruments****Foreign Exchange Risk**

A significant portion of our revenue, earnings and net investment in foreign affiliates is exposed to changes in foreign exchange rates. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities. Depending on market conditions, foreign exchange risk is also managed through the use of derivative financial instruments. These financial instruments serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions. The aggregate notional amount of foreign

exchange derivative financial instruments offsetting foreign currency exposures was \$1.3 billion and \$1.1 billion, as of September 27, 2015, and December 31, 2014, respectively. The derivative financial instruments primarily offset exposures in the euro, U.K. pound, and Japanese Yen. The vast majority of the foreign exchange derivative financial instruments mature within 60 days and all mature within 180 days.

All derivative contracts used to manage foreign currency risk are measured at fair value and are reported as assets or liabilities on the condensed consolidated balance sheet. The company has not designated the foreign currency forward-exchange contracts as hedging instruments. We recognize the gains and losses on forward-exchange contracts that are used to offset the same foreign currency assets or liabilities immediately into earnings along with the earnings impact of the items they generally offset. These contracts essentially take the opposite currency position of that reflected in the month-end balance sheet to counterbalance the effect of any currency movement.

Table of Contents

## Interest Rate Risk

The company may use interest rate swap contracts on certain investing and borrowing transactions to manage its net exposure to interest rates and to reduce its overall cost of borrowing. In anticipation of issuing fixed-rate debt, we may use forward-starting interest rate swaps that are designated as cash flow hedges to hedge against changes in interest rates that could impact expected future issuances of debt. To the extent these hedges of cash flows related to anticipated debt are effective, any unrealized gains or losses on the forward-starting interest rate swaps are reported in Accumulated other comprehensive loss and are recognized in income over the life of the future fixed-rate notes. When the company discontinues hedge accounting because it is no longer probable that an anticipated transaction will occur within the originally expected period of execution, or within an additional two-month period thereafter, changes to fair value accumulated in other comprehensive income are recognized immediately in earnings.

In the third quarter of 2015, we entered into four interest rate swaps with an aggregate notional value of \$300 million. We designated these swaps as cash flow hedges against interest rate exposure related principally to the anticipated future issuance of fixed-rate debt to be used primarily to refinance our 1.150% senior notes due in 2016. Contracts outstanding at September 27, 2015, have a mandatory termination within three months.

## Fair Value of Derivative Instruments

The location and fair values of derivative instruments are as follows:

(MILLIONS OF DOLLARS)	Balance Sheet Location	Fair Value of Derivatives	
		September 27, 2015	December 31, 2014
<b>Derivatives Designated as Hedging Instruments:</b>			
Interest rate swap contracts	Other current liabilities	\$(6 )	\$—
Total derivatives designated as hedging instruments		(6 )	—
<b>Derivatives Not Designated as Hedging Instruments</b>			
Foreign currency forward-exchange contracts	Other current assets	\$18	\$9
Foreign currency forward-exchange contracts	Other current liabilities	(9 )	(4 )
Total derivatives not designated as hedging instruments		\$9	\$5
Total derivatives		\$3	\$5

We use a market approach in valuing financial instruments on a recurring basis. Our derivative financial instruments are measured at fair value on a recurring basis using Level 2 inputs in the calculation of fair value.

The amount of losses on derivative instruments designated as cash flow hedges, recorded, net of tax, in Accumulated other comprehensive loss, are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Interest rate swap contracts	\$(3 )	\$—	\$(3 )	\$—

The amounts of gains/(losses) on derivative instruments not designated as hedging instruments, recorded in Other (income)/deductions, are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Foreign currency forward-exchange contracts	\$18	\$(1 )	\$24	\$(1 )

These amounts were substantially offset in Other (income)/deductions—net by the effect of changing exchange rates on the underlying foreign currency exposures.



Table of Contents

## 10. Inventories

The components of inventory follow:

(MILLIONS OF DOLLARS)	September 27, 2015	December 31, 2014
Finished goods	\$682	\$688
Work-in-process	360	340
Raw materials and supplies	361	261
Inventories	\$1,403	\$1,289

## 11. Goodwill and Other Intangible Assets

## A. Goodwill

Prior to the second quarter of 2015, our businesses were managed through four operating segments, and they are now managed through two operating segments: U.S. and International. See Note 17. Segment and Other Revenue Information for additional information.

The components of, and changes in, the carrying amount of goodwill follow:

(MILLIONS OF DOLLARS)	U.S.	International	Total
Balance, December 31, 2014	\$501	\$475	\$976
Additions <sup>(a)</sup>	164	38	202
Other <sup>(b)</sup>	—	(15	) (15
Balance, September 27, 2015	\$665	\$498	\$1,163

Primarily reflects the allocation to reportable segments of goodwill associated with the acquisition of certain assets<sup>(a)</sup> of Abbott Animal Health (amounts recorded are preliminary and subject to final valuation). For additional information, see Note 5. Acquisitions and Divestitures—Acquisition of Abbott Animal Health.

Includes adjustments for foreign currency translation, as well as a reclassification adjustment of \$2 million to<sup>(b)</sup> Assets held for sale. For additional information associated with this pending sale, see Note 5. Acquisitions and Divestitures—Assets Held for Sale.

The gross goodwill balance was \$1,699 million and \$1,512 million as of September 27, 2015, and December 31, 2014, respectively. Accumulated goodwill impairment losses (generated entirely in fiscal 2002) were \$536 million as of September 27, 2015, and December 31, 2014.

## B. Other Intangible Assets

The components of identifiable intangible assets follow:

	As of September 27, 2015			As of December 31, 2014		
	Gross		Identifiable Intangible Assets	Gross		Identifiable Intangible Assets
	Carrying Amount	Accumulated Amortization	Less Accumulated Amortization	Carrying Amount	Accumulated Amortization	Less Accumulated Amortization
(MILLIONS OF DOLLARS)						
Finite-lived intangible assets:						
Developed technology rights <sup>(a)</sup>	\$716	\$(287)	\$429	\$744	\$(259)	\$485
Brands	212	(119)	93	216	(111)	105
Trademarks and trade names <sup>(a)</sup>	63	(43)	20	60	(41)	19
Other <sup>(a)</sup>	133	(118)	15	119	(116)	3
Total finite-lived intangible assets	1,124	(567)	557	1,139	(527)	612
Indefinite-lived intangible assets:						
Brands	39	—	39	38	—	38
Trademarks and trade names	67	—	67	67	—	67
In-process research and development <sup>(a)</sup>	8	—	8	2	—	2
Product rights	8	—	8	8	—	8
Total indefinite-lived intangible assets	122	—	122	115	—	115
Identifiable intangible assets	\$1,246	\$(567)	\$679	\$1,254	\$(527)	\$727

<sup>(a)</sup> Includes the acquisition of intangible assets associated with the purchase of certain assets of Abbott Animal Health in the first quarter of 2015 (amounts recorded are preliminary and subject to final valuation), as well as the impact of foreign exchange. For additional information, see Note 5. Acquisitions and Divestitures—Acquisition of Abbott Animal Health.

## C. Amortization

Amortization expense related to acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in Amortization of intangible assets as it benefits multiple business functions. Amortization expense related to acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate. Total amortization expense for finite-lived intangible assets was \$16 million and \$47 million for the three and nine months ended September 27, 2015, respectively, and \$15 million and \$47 million for the three and nine months ended September 28, 2014, respectively.

## 12. Benefit Plans

Prior to the Separation from Pfizer, employees who met certain eligibility requirements participated in various defined benefit pension plans and postretirement plans administered and sponsored by Pfizer. Effective December 31, 2012, our employees ceased to participate in the Pfizer U.S. qualified defined benefit and U.S. retiree medical plans, and liabilities associated with our employees under these plans were retained by Pfizer. Pfizer is continuing to credit certain employees' service with Zoetis generally through December 31, 2017 (or termination of employment from Zoetis, if earlier) for certain early retirement benefits with respect to Pfizer's U.S. defined benefit pension and retiree medical plans. Pension and postretirement benefit expense associated with the extended service for certain employees in the U.S. plans totaled approximately \$2 million in each three month period ended September 27, 2015, and September 28, 2014, respectively, and approximately \$5 million in each nine month period ended September 27,

2015, and September 28, 2014, respectively.

As part of the Separation (see Note 2. The Separation and Transactions and Agreements with Pfizer), certain separation adjustments were made to transfer the assets and liabilities of certain international defined benefit pension plans from Pfizer to Zoetis. During the first nine months of 2014, our pension plans in Australia, Japan and Switzerland were transferred to us from Pfizer. The net pension obligation (approximately \$3 million) and the related accumulated other comprehensive loss (approximately \$3 million, net of tax) associated with these plans were recorded. During the remainder of 2014, our pension plan in Belgium was also transferred to us from Pfizer. During the third quarter of 2015, our pension plan in the Philippines was transferred to us from Pfizer. The net pension obligation (approximately \$1 million) and the related accumulated other comprehensive loss (which was less than \$1 million, net of tax) associated with this plan were recorded. Prior to the Separation and transfer, these benefit plans were accounted for as multi-employer plans.

14 |

---

The following table provides the net periodic benefit cost associated with dedicated pension plans (including those transferred to us):

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Service cost	\$2	\$1	\$6	\$3
Interest cost	1	1	3	2
Expected return on plan assets	(1	) —	(2	) —
Amortization of net actuarial loss	—	—	1	—
Settlement loss <sup>(a)</sup>	1	—	1	4
Net periodic benefit cost	\$3	\$2	\$9	\$9

(a) The nine months ended September 28, 2014 includes a first quarter settlement charge of approximately \$4 million (\$3 million, net of tax) associated with the 2012 sale of our Netherlands manufacturing facility.

Total company contributions to the dedicated international pension plans were \$3 million and \$6 million for the three and nine months ended September 27, 2015, respectively, and \$1 million and \$3 million for the three and nine months ended September 28, 2014, respectively. We expect to contribute a total of approximately \$8 million to these plans in 2015.

Pension expense associated with international benefit plans accounted for as multi-employer plans was approximately \$1 million and \$4 million for the three months and nine months ended September 28, 2014, respectively.

Contributions to these plans were approximately \$1 million and \$3 million for the three and nine months ended September 28, 2014, respectively. There were no plans accounted for as multi-employer plans in 2015.

### 13. Share-Based Payments

The company may grant a variety of share-based payments under the Zoetis 2013 Equity and Incentive Plan (the Equity Plan) to employees and non-employee directors. The principal types of share-based awards available under the Equity Plan may include, but are not limited to, stock options, restricted stock and restricted stock units (RSUs), deferred stock unit awards (DSUs), performance share unit awards (PSUs) and other equity-based or cash-based awards.

The components of share-based compensation expense follow:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Stock options / stock appreciation rights	\$3	\$5	\$14	\$12
RSUs / DSUs	6	4	15	10
PSUs	1	—	2	—
Share-based compensation expense—total	\$10	\$9	\$31	\$22

(a) For the three and nine months ended September 27, 2015, we capitalized \$1 million of share-based compensation expense to inventory.

During the nine months ended September 27, 2015, the company granted 862,403 stock options with a weighted-average exercise price of \$46.01 per stock option and a weighted-average fair value of \$11.70 per option. The fair-value based method for valuing each Zoetis stock option grant on the grant date uses the Black-Scholes-Merton option-pricing model, which incorporates a number of valuation assumptions. The expected volatility assumption required for the Black-Scholes-Merton model for the 2015 grant was calculated using a 2-year historical volatility of the Zoetis stock price and weighting it equally against the implied volatility. Prior to 2015, the company had used an implied volatility. The selection of the blended historical and implied volatility approach was based on our assessment that this calculation of expected volatility is more representative of future stock price trends. The weighted-average fair value was estimated based on the following assumptions: risk-free interest rate of 1.79%; expected dividend yield of 0.72%; expected stock price volatility of 23.92%; and expected term of 6.5 years. The values determined through this fair-value based method generally are amortized on a straight-line basis over the

vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

During the nine months ended September 27, 2015, the company granted 710,966 RSUs with a weighted-average grant date fair value of \$46.06 per RSU. RSUs are accounted for using a fair-value-based method that utilizes the closing price of Zoetis common stock on the date of grant. In general, RSUs vest after three years of continuous service from the grant date and the values are amortized on a straight-line basis over the vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

During the nine months ended September 27, 2015, the company granted 157,130 PSUs with a weighted-average grant date fair value of \$63.14 per PSU. PSUs are accounted for using a Monte Carlo simulation model. The units underlying the PSUs will be earned and vested over a three-year performance period, based upon the total shareholder return of the company in comparison to the total shareholder return of the companies comprising the S&P 500 index at the start of the performance period (Relative TSR). The weighted-average fair value was estimated based on volatility assumptions of Zoetis common stock and an average of peer companies, which were 21.8% and 23.5%, respectively. Depending on the company's Relative TSR performance at the end of the performance period, the recipient may earn between 0% and 200% of the target number of

Table of Contents

units. Vested units are settled in shares of the company's common stock. PSU values are amortized on a straight-line basis over the vesting term into Cost of sales, Selling, general and administrative expenses, or Research and development expenses, as appropriate.

As a result of our operational efficiency initiative and supply network strategy, the company accelerated the vesting, and in some cases the settlement on a pro-rata basis, of outstanding RSUs of terminated employees, subject, in each case, to the requirements of Section 409A of the U.S. Internal Revenue Code, the terms of the Equity Plan and the applicable award agreements, and any outstanding deferral elections. Generally, unvested stock options previously granted to terminated employees accelerated in full, and employees generally have the ability to exercise the stock options for three months after termination. Zoetis employees who held stock options and were retirement eligible as of their termination date generally have the full term of the stock option to exercise. In addition, outstanding PSUs of terminated employees vested on a pro-rata basis will be settled on or after the third anniversary of the grant date, subject to the achievement of performance goals. The unvested portion of RSUs and PSAs were forfeited. The accelerated vesting of the outstanding stock options and the settlement, on a pro-rata basis, of other equity awards resulted in the recognition of additional stock-based compensation expense for the three and nine months ended September 27, 2015, of approximately \$1 million, which is included in Restructuring charges and certain acquisition-related costs.

## 14. Stockholders' Equity

Zoetis is authorized to issue 6,000,000,000 shares of common stock and 1,000,000,000 shares of preferred stock. Changes in common shares and treasury stock were as follows:

(MILLIONS OF DOLLARS AND SHARES)	Common Shares Issued <sup>(a)</sup>	Treasury Stock <sup>(a)</sup>	Cost of Treasury Stock
Balance, December 31, 2013	500.008	—	\$—
Stock-based compensation <sup>(b)</sup>	0.100	0.014	0.4
Defined contribution plan	1.102	—	—
Balance, September 28, 2014	501.209	0.014	\$0.4
Balance, December 31, 2014	501.342	0.015	\$0.5
Stock-based compensation <sup>(b)</sup>	0.231	0.037	1.5
Share repurchase program <sup>(c)</sup>	—	3.189	148.1
Balance, September 27, 2015	501.574	3.240	\$150.1

<sup>(a)</sup> Shares may not add due to rounding.

Treasury shares associated with stock-based compensation are reacquired from employees to satisfy tax

<sup>(b)</sup> withholding requirements on the vesting of restricted shares from equity-based awards. For additional information regarding share-based compensation, see Note 13. Share-Based Payments.

In November 2014, the company's Board of Directors authorized a \$500 million share repurchase program.

<sup>(c)</sup> Purchases of Zoetis shares may be made at the discretion of management, depending on market conditions and business needs. As of September 27, 2015, there was approximately \$352 million remaining under this authorization.

Changes, net of tax, in accumulated other comprehensive loss, excluding noncontrolling interest, follow:

(MILLIONS OF DOLLARS)	Derivatives Net Unrealized Gains/(Losses)	Currency Translation Adjustment Net Unrealized Gains/(Losses)	Benefit Plans Actuarial Gains/(Losses)	Accumulated Other Comprehensive Loss
Balance, December 31, 2014	\$—	\$(336)	\$(25)	\$(361)
Other comprehensive income (loss), net of tax	(3)	(199)	1	(201)
Balance, September 27, 2015	\$(3)	\$(535)	\$(24)	\$(562)



Table of Contents

## 15. Earnings per Share

The following table presents the calculation of basic and diluted earnings per share:

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA)				
Numerator				
Net income before allocation to noncontrolling interests	\$ 190	\$ 167	\$ 319	\$ 461
Less: net income attributable to noncontrolling interests	1	1	2	4
Net income attributable to Zoetis Inc.	\$ 189	\$ 166	\$ 317	\$ 457
Denominator				
Weighted-average common shares outstanding	499.239	501.453	500.186	500.887
Common stock equivalents: stock options, RSUs, PSUs and DSUs	2.414	0.992	2.294	0.723
Weighted-average common and potential dilutive shares outstanding	501.653	502.445	502.480	501.610
Earnings per share attributable to Zoetis Inc. stockholders—basic	\$0.38	\$0.33	\$0.63	\$0.91
Earnings per share attributable to Zoetis Inc. stockholders—diluted	\$0.38	\$0.33	\$0.63	\$0.91

There were approximately 0.9 million and 0.7 million stock options outstanding for the three and nine months ended September 27, 2015, respectively, and 3 million and 2 million stock options outstanding for the three and nine months ended September 28, 2014, respectively, under the company's Equity Plan that were excluded from the computation of diluted earnings per share, as the effect would have been anti-dilutive.

## 16. Commitments and Contingencies

We and certain of our subsidiaries are subject to numerous contingencies arising in the ordinary course of business. For a discussion of our tax contingencies, see Note 8. Income Taxes.

## A. Legal Proceedings

Our non-tax contingencies include, among others, the following:

- Product liability and other product-related litigation, which can include injury, consumer, off-label promotion, antitrust and breach of contract claims.

- Commercial and other matters, which can include product-pricing claims and environmental claims and proceedings.

- Patent litigation, which typically involves challenges to the coverage and/or validity of our patents or those of third parties on various products or processes.

- Government investigations, which can involve regulation by national, state and local government agencies in the United States and in other countries.

Certain of these contingencies could result in losses, including damages, fines and/or civil penalties, and/or criminal charges, which could be substantial.

We believe that we have strong defenses in these types of matters, but litigation is inherently unpredictable and excessive verdicts do occur. We do not believe that any of these matters will have a material adverse effect on our financial position. However, we could incur judgments, enter into settlements or revise our expectations regarding the outcome of certain matters, and such developments could have a material adverse effect on our results of operations or cash flows in the period in which the amounts are paid.

We have accrued for losses that are both probable and reasonably estimable. Substantially all of these contingencies are subject to significant uncertainties and, therefore, determining the likelihood of a loss and/or the measurement of any loss can be complex. Consequently, we are unable to estimate the range of reasonably possible loss in excess of amounts accrued. Our assessments are based on estimates and assumptions that have been deemed reasonable by



management, but the assessment process relies heavily on estimates and assumptions that may prove to be incomplete or inaccurate, and unanticipated events and circumstances may occur that might cause us to change those estimates and assumptions.

Amounts recorded for legal and environmental contingencies can result from a complex series of judgments about future events and uncertainties and can rely heavily on estimates and assumptions.

The principal matters to which we are a party are discussed below. In determining whether a pending matter is significant for financial reporting and disclosure purposes, we consider both quantitative and qualitative factors in order to assess materiality, such as, among other things, the amount of damages and the nature of any other relief sought in the proceeding, if such damages and other relief are specified; our view of the merits of the claims and of the strength of our defenses; whether the action purports to be a class action and our view of the likelihood that a class will be certified by the court; the jurisdiction in which the proceeding is pending; any experience that we or, to our

Table of Contents

knowledge, other companies have had in similar proceedings; whether disclosure of the action would be important to a reader of our financial statements, including whether disclosure might change a reader's judgment about our financial statements in light of all of the information about the company that is available to the reader; the potential impact of the proceeding on our reputation; and the extent of public interest in the matter. In addition, with respect to patent matters, we consider, among other things, the financial significance of the product protected by the patent.

**PregSure®**

We have received in total approximately 255 claims in Europe and New Zealand seeking damages related to calves claimed to have died of Bovine Neonatal Pancytopenia (BNP) on farms where PregSure BVD, a vaccine against Bovine Virus Diarrhea (BVD), was used. BNP is a rare syndrome that first emerged in cattle in Europe in 2006. Studies of BNP suggest a potential association between the administration of PregSure and the development of BNP, although no causal connection has been established. The cause of BNP is not known.

In 2010, we voluntarily stopped sales of PregSure BVD in Europe, and recalled the product at wholesalers while investigations into possible causes of BNP continued. In 2011, after incidences of BNP were reported in New Zealand, we voluntarily withdrew the marketing authorization for PregSure throughout the world.

We have settled more than half of these claims for amounts that are not material individually or in the aggregate. Investigations into possible causes of BNP continue and these settlements may not be representative of any future claims resolutions.

**Ulianopolis, Brazil**

In February 2012, the Municipality of Ulianopolis (State of Para, Brazil) filed a complaint against Fort Dodge Saúde Animal Ltda. (FDSAL) and five other large companies alleging that waste sent to a local waste incineration facility for destruction, but that was not ultimately destroyed as the facility lost its operating permit, caused environmental impacts requiring cleanup.

The Municipality is seeking recovery of cleanup costs purportedly related to FDSAL's share of all waste accumulated at the incineration facility awaiting destruction, and compensatory damages to be allocated among the six defendants. We believe we have strong arguments against the claim, including defense strategies against any claim of joint and several liability.

At the request of the Municipal prosecutor, in April 2012, the lawsuit was suspended for one year. Since that time, the prosecutor has initiated investigations into the Municipality's actions in the matter as well as the efforts undertaken by the six defendants to remove and dispose of their individual waste from the incineration facility. On October 3, 2014, the Municipal prosecutor announced that the investigation remained ongoing and outlined the terms of a proposed Term of Reference (a document that establishes the minimum elements to be addressed in the preparation of an Environmental Impact Assessment), under which the companies would be liable to withdraw the waste and remediate the area. On March 5, 2015, we presented our response to the prosecutor's proposed Term of Reference, arguing that the proposed terms were overly general in nature, and expressing our interest in discussing alternatives to address the matter. The prosecutor agreed to consider our request to engage a technical consultant to conduct an environmental diagnostic of the contaminated area. On May 29, 2015, we, in conjunction with the other defendant companies, submitted a draft cooperation agreement to the prosecutor, which outlined the proposed terms and conditions for the engagement of a technical consultant to conduct the environmental diagnostic. The prosecutor, however, denied the proposal and reiterated his request that each defendant agree to become a signatory to the Term of Reference, as originally proposed. On October 5, 2015, we informed the prosecutor of our decision not to sign the Term Reference and requested a face-to-face meeting to clarify the scope and methodology of the preliminary assessment, to understand the exact reasons for the rejection of our proposal to engage a technical consultant, and to discuss alternative scenarios. The prosecutor granted our request and scheduled the face-to-face meeting for November 6, 2015.

**Lascadoil Contamination in Animal Feed**

An investigation by the U.S. Food and Drug Administration (FDA) and the Michigan Department of Agriculture is ongoing to determine how lascadoil, oil for industrial use, made its way into the feed supply of certain turkey and hog feed mills in Michigan. The contaminated feed is believed to have caused the deaths of approximately 50,000 turkeys and the contamination (but not death) of at least 20,000 hogs in August 2014. While it remains an open question as to

how the lascaldoil made its way into the animal feed, the allegations are that lascaldoil intended to be sold for reuse as biofuel was inadvertently sold to producers of soy oil, who in turn unknowingly sold the contaminated soy oil to fat recycling vendors, who then sold the contaminated soy oil to feed mills for use in animal feed. Indeed, related to the FDA investigation, Shur-Green Farms LLC, a producer of soy oil, recalled certain batches of soy oil allegedly contaminated with lascaldoil on October 13, 2014.

During the course of its investigation, the FDA identified the process used to manufacture Zoetis' Avatec® (lasalocid sodium) and Bovatec® (lasalocid sodium) products as one possible source of the lascaldoil, since lascaldoil contains small amounts of lasalocid, the active ingredient found in both products. Zoetis has historically sold any and all industrial lascaldoil byproduct to an environmental company specializing in waste disposal. The environmental company is contractually obligated to incinerate the lascaldoil or resell it for use in biofuel. Under the terms of the agreement, the environmental company is expressly prohibited from reselling the lascaldoil to be used as a component in food. The FDA inspected the Zoetis site where Avatec and Bovatec are manufactured, and found no evidence that Zoetis was involved in the contamination of the animal feed.

On March 10, 2015, plaintiffs Restaurant Recycling, LLC (Restaurant Recycling) and Superior Feed Ingredients, LLC (Superior), both of whom are in the fat recycling business, filed a complaint against Shur-Green Farms alleging negligence and breach of warranty claims arising from their purchase of soy oil allegedly contaminated with lascaldoil. Plaintiffs resold the allegedly contaminated soy oil to turkey feed mills for use in feed ingredient. Plaintiffs also named Zoetis as a defendant in the complaint alleging that Zoetis failed to properly manufacture its products and breached an implied warranty that the soy oil was fit for use at turkey and hog mills. Zoetis was served with the complaint on June 3, 2015, and we filed our answer, denying all allegations, on July 15, 2015. On August 10, 2015, several of the turkey feed mills filed a

## Table of Contents

joint complaint against Restaurant Recycling, Superior, Shur-Green Farms and others, alleging claims for negligence, misrepresentation, and breach of warranty, arising out of their alleged purchase and use of the contaminated soy oil. The complaint also named Zoetis as a defendant, but failed to raise any claims against Zoetis directly. The turkey-mill plaintiffs have attempted to address that deficiency by recently filing an amended complaint, and we are in the process of preparing our answer.

We believe we have strong arguments against all claims and do not believe there is any liability on the part of Zoetis.

### Other Matters

The European Commission published a decision on alleged competition law infringements by several human health pharmaceutical companies on June 19, 2013. One of the involved legal entities is Alpharma, LLC, formerly having the name Alpharma Inc. Alpharma, LLC's involvement is solely related to its human health activities prior to Pfizer's acquisition of King/Alpharma. Zoetis paid a fine in the amount of Euro 11 million (approximately \$14 million) and was reimbursed by Pfizer in accordance with the Global Separation Agreement between Pfizer and Zoetis, which provides that Pfizer is obligated to indemnify Zoetis for any liabilities arising out of claims not related to its animal health assets. We filed an appeal of the decision on September 6, 2013; the appeal remains pending.

In July 2014, we reached a commercial settlement with several large poultry customers in Mexico associated with specific lots of a Zoetis poultry vaccine. Although there have been no quality or efficacy issues with the manufacturing of this vaccine, certain shipments from several lots in Mexico may have experienced an issue in storage with a third party in Mexico that could have impacted their efficacy. We issued a recall of these lots in July 2014 and the product is currently unavailable in Mexico. We recorded a \$13 million charge in Other (income)/deductions—net in the second quarter of 2014, and we do not expect any significant additional charges related to this issue. In the third quarter of 2014, we were notified of an insurance recovery of \$1 million and have recorded this in Other (income)/deductions—net.

On March 30, 2015, we were served with a complaint filed in the U.S. District Court for the Eastern District of Pennsylvania by two additional customers in Mexico, alleging damages suffered as a result of the use of poultry vaccines obtained from the recalled lots discussed above. We have moved to dismiss the complaint in its entirety on grounds that the complaint fails to properly state a claim on which relief can be granted. On September 16, 2015, the Court granted the motion in part and denied it in part, dismissing all claims arising out of tort or fraud. As a result, the only claims remaining in the lawsuit are based in contract, namely breach of express warranty, breach of certain implied warranties, and unjust enrichment.

### B. Guarantees and Indemnifications

In the ordinary course of business and in connection with the sale of assets and businesses, we indemnify our counterparties against certain liabilities that may arise in connection with the transaction or related to activities prior to the transaction. These indemnifications typically pertain to environmental, tax, employee and/or product-related matters and patent-infringement claims. If the indemnified party were to make a successful claim pursuant to the terms of the indemnification, we would be required to reimburse the loss. These indemnifications are generally subject to threshold amounts, specified claim periods and other restrictions and limitations. Historically, we have not paid significant amounts under these provisions and, as of September 27, 2015, recorded amounts for the estimated fair value of these indemnifications were not significant.

## 17. Segment and Other Revenue Information

### A. Segment Information

In the second quarter of 2015, we changed our segment reporting structure to reflect the way management makes operating decisions. We consolidated our prior Europe/Africa/Middle East (EuAfME), Canada/Latin America (CLAR) and Asia/Pacific (APAC) operating segments into one operating segment. As a result, the company's new segment reporting structure consists of two reportable segments: the United States and International. We also recategorized certain costs that are not allocated to our operating segments. There has been no change in our total condensed consolidated financial condition or results of operations previously reported as a result of the change in our segment structure. The prior period presentation has been revised to reflect the new segment reporting structure. We manage our operations through two geographic regions. Each operating segment has responsibility for its commercial activities. Within each of these operating segments, we offer a diversified product portfolio, including

vaccines, parasiticides, anti-infectives, medicated feed additives and other pharmaceuticals, for both livestock and companion animal customers.

**Operating Segments**

Our operating segments are the United States and International. Our chief operating decision maker uses the revenue and earnings of the two operating segments, among other factors, for performance evaluation and resource allocation.

**Other Costs and Business Activities**

Certain costs are not allocated to our operating segment results, such as costs associated with the following:

Other business activities includes our Client Supply Services (CSS) contract manufacturing results, as well as expenses associated with our dedicated veterinary medicine research and development organization, research alliances, U.S. regulatory affairs and other operations focused on the development of our products. Other R&D-related costs associated with non-U.S. market and regulatory activities are generally included in the international commercial segment.

Table of Contents

Corporate, which is responsible for platform functions such as business technology, facilities, legal, finance, human resources, business development, and communications, among others. These costs also include compensation costs and other miscellaneous operating expenses not charged to our operating segments, as well as interest income and expense.

Certain transactions and events such as (i) Purchase accounting adjustments, where we incur expenses associated with the amortization of fair value adjustments to inventory, intangible assets and property, plant and equipment; (ii) Acquisition-related activities, where we incur costs for restructuring and integration; and (iii) Certain significant items, which includes non-acquisition-related restructuring charges, certain asset impairment charges, stand-up costs and costs associated with cost reduction/productivity initiatives.

Other unallocated includes (i) certain overhead expenses associated with our global manufacturing operations not charged to our operating segments; (ii) certain costs associated with business technology and finance that specifically support our global manufacturing operations; (iii) certain supply chain and global logistics costs; and (iv) procurement costs.

**Segment Assets**

We manage our assets on a total company basis, not by operating segment. Therefore, our chief operating decision maker does not regularly review any asset information by operating segment and, accordingly, we do not report asset information by operating segment. Total assets were approximately \$6.7 billion at September 27, 2015, and \$6.6 billion at December 31, 2014.

**Selected Statement of Income Information**

	Earnings		Depreciation and Amortization <sup>(a)</sup>	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS)				
Three months ended				
U.S.				
Revenue	\$632	\$532		
Cost of Sales	147	126		
Gross Profit	485	406		
Gross Margin	76.7	% 76.3	%	
Operating Expenses	100	93		
Other (income)/deductions	(1	) —		
U.S. Earnings	386	313	\$5	\$7
International				
Revenue <sup>(b)</sup>	569	666		
Cost of Sales	209	241		
Gross Profit	360	425		
Gross Margin	63.3	% 63.8	%	
Operating Expenses	137	168		
Other (income)/deductions	4	2		
International Earnings	219	255	10	13
Total operating segments	605	568	15	20
Other business activities <sup>(c)</sup>	(73	) (76	) 6	7
Reconciling Items:				
Corporate <sup>(d)</sup>	(138	) (142	) 9	7

Edgar Filing: Zoetis Inc. - Form 10-Q

Purchase accounting adjustments <sup>(e)</sup>	(13	)	(13	)	14	13
Acquisition-related costs <sup>(f)</sup>	(6	)	(1	)	—	—
Certain significant items <sup>(g)</sup>	(46	)	(38	)	1	1
Other unallocated <sup>(h)</sup>	(56	)	(60	)	1	2
Total Earnings <sup>(i)</sup>	\$273		\$238		\$46	\$50

201

---

Table of Contents

(MILLIONS OF DOLLARS)	Earnings		Depreciation and Amortization <sup>(a)</sup>	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Nine months ended U.S.				
Revenue	\$ 1,692	\$ 1,470		
Cost of Sales	399	343		
Gross Profit	1,293	1,127		
Gross Margin	76.4	% 76.7	%	
Operating Expenses	274	278		
Other (income)/deductions	(1	) —		
U.S. Earnings	1,020	849	\$ 18	\$ 24
International				
Revenue <sup>(b)</sup>	1,762	1,956		
Cost of Sales	638	701		
Gross Profit	1,124	1,255		
Gross Margin	63.8	% 64.2	%	
Operating Expenses	423	490		
Other (income)/deductions	10	5		
International Earnings	691	760	34	38
Total operating segments	1,711	1,609	52	62
Other business activities <sup>(c)</sup>	(208	) (224	) 19	21
Reconciling Items:				
Corporate <sup>(d)</sup>	(392	) (389	) 28	21
Purchase accounting adjustments <sup>(e)</sup>	(41	) (38	) 39	38
Acquisition-related costs <sup>(f)</sup>	(11	) (5	) —	—
Certain significant items <sup>(g)</sup>	(406	) (127	) 3	4
Other unallocated <sup>(h)</sup>	(177	) (161	) 3	5
Total Earnings <sup>(i)</sup>	\$ 476	\$ 665	\$ 144	\$ 151

<sup>(a)</sup> Certain production facilities are shared. Depreciation and amortization is allocated to the reportable operating segments based on estimates of where the benefits of the related assets are realized.

Revenue denominated in euros was \$139 million and \$425 million for the three and nine months ended

<sup>(b)</sup> September 27, 2015, respectively, and \$175 million and \$525 million for the three and nine months ended September 28, 2014, respectively.

<sup>(c)</sup> Other business activities reflects the R&D costs managed by our Research and Development organization, as well as revenue and expenses related to our contract manufacturing business.

<sup>(d)</sup> Corporate includes, among other things, administration expenses, interest expense, certain compensation and other costs not charged to our operating segments.

<sup>(e)</sup> Purchase accounting adjustments includes certain charges related to intangible assets and property, plant and equipment not charged to our operating segments, and the fair value adjustments to acquired inventory.

<sup>(f)</sup> Acquisition-related costs can include costs associated with acquiring, integrating and restructuring acquired businesses, such as allocated transaction costs, integration costs, restructuring charges and additional depreciation associated with asset restructuring. For additional information, see Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.



Certain significant items includes substantive, unusual items that, either as a result of their nature or size, would not be expected to occur as part of our normal business on a regular basis. Such items primarily include certain (g) costs related to becoming an independent public company, restructuring charges and implementation costs associated with our cost-reduction/productivity initiatives that are not associated with an acquisition, certain legal and commercial settlements and the impact of divestiture-related gains and losses.

For the third quarter of 2015, Certain significant items primarily includes: (i) Zoetis stand-up costs of \$22 million; and (ii) charges related to our operational efficiency initiative and supply network strategy of \$24 million. Stand-up costs include certain nonrecurring costs related to becoming an independent public company, such as new branding (including changes to the manufacturing process for required new packaging), the creation of standalone systems and infrastructure, site separation, and certain legal registration and patent assignment costs.

For the third quarter of 2014, Certain significant items primarily includes: (i) Zoetis stand-up costs of \$32 million; (ii) intangible asset impairment charges related to an IPR&D project acquired with the FDAH acquisition in 2009 of \$6 million; and (iii) restructuring charges of \$1 million related to employee severance costs in Europe.

Table of Contents

For the nine months ended September 27, 2015, Certain significant items primarily includes: (i) Zoetis stand-up costs of \$84 million; (ii) charges related to our operational efficiency initiative and supply network strategy of \$317 million; (iii) an impairment of IPR&D assets of \$2 million related to the termination of a canine oncology project; and (iv) charges due to unusual investor-related activities of \$3 million.

For the nine months ended September 28, 2014, Certain significant items primarily includes: (i) Zoetis stand-up costs of \$106 million; (ii) charges related to a commercial settlement in Mexico of \$13 million, partially offset by the insurance recovery of \$1 million income; (iii) restructuring charges of \$6 million related to employee severance costs in Europe, partially offset by a \$2 million benefit related to a reversal of a previously established reserve as a result of a change in estimate of severance costs; (iv) intangible asset impairment charges related to an IPR&D project acquired with the FDAH acquisition in 2009 of \$6 million; (v) the Zoetis portion of a net gain on the sale of land by our Taiwan joint venture of \$3 million; (vi) additional depreciation associated with asset restructuring of \$1 million; (vii) a pension plan settlement charge related to the divestiture of a manufacturing plant of \$4 million; and (viii) an insurance recovery of litigation-related charges of \$2 million income.

(h) Includes overhead expenses associated with our manufacturing and supply operations, as well as procurement costs.

(i) Defined as income before provision for taxes on income.

**B. Other Revenue Information****Revenue by Species**

Significant species revenue are as follows:

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS)				
Livestock:				
Cattle	\$432	\$437	\$1,201	\$1,207
Swine	163	179	495	496
Poultry	132	147	399	428
Other	23	27	60	68
	750	790	2,155	2,199
Companion Animal:				
Horses	35	38	117	127
Dogs and Cats	416	370	1,182	1,100
	451	408	1,299	1,227
Contract Manufacturing	13	12	37	39
Total revenue	\$1,214	\$1,210	\$3,491	\$3,465

**Revenue by Major Product Category**

Significant revenue by major product category are as follows:

	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
(MILLIONS OF DOLLARS)				
Anti-infectives	\$348	\$356	\$938	\$965
Vaccines	301	308	858	886
Parasiticides	158	178	504	528
Medicated feed additives	124	124	364	337
Other pharmaceuticals	226	200	650	598
Other non-pharmaceuticals	44	32	140	112

Edgar Filing: Zoetis Inc. - Form 10-Q

Contract manufacturing	13	12	37	39
Total revenue	\$1,214	\$1,210	\$3,491	\$3,465

22 |

---

Table of Contents

18. Subsequent Events

On November 2, 2015, we announced an agreement to purchase PHARMAQ, an animal health company specializing in aquatic health, based in Oslo, Norway, for \$765 million (adjusted to reflect working capital and net indebtedness as of the closing date). The company generated revenue of approximately \$80 million in 2014 and markets its products in the major fish-producing markets. We expect to complete the acquisition in the fourth quarter of 2015 and we intend on drawing on our revolving credit facility to finance the transaction.

Also on November 2, 2015, we amended a financial covenant in our existing \$1 billion revolving credit facility mentioned above to increase the existing maximum total leverage ratio from 3.50:1 to 4.25:1 only upon entering into a material acquisition, as defined. The amended ratio extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. See Note 9A. Financial Instruments—Debt: Credit Facilities for additional information regarding the existing facility and leverage ratio.

Table of Contents

Review Report of Independent Registered Public Accounting Firm  
The Shareholders and Board of Directors  
Zoetis Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Zoetis Inc. and subsidiaries (the Company) as of September 27, 2015, the related condensed consolidated statements of income and comprehensive income for the three and nine-month periods ended September 27, 2015 and September 28, 2014, and the related condensed consolidated statements of equity and cash flows for the nine-month periods ended September 27, 2015 and September 28, 2014. These condensed consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements as of September 27, 2015 and for the three and nine-month periods ended September 27, 2015 and September 28, 2014 referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Zoetis Inc. and subsidiaries as of December 31, 2014, and the related consolidated statements of income, comprehensive income, equity, and cash flows for the year then ended (not presented herein); and in our report dated February 27, 2015, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2014, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP  
New York, New York  
November 5, 2015

Table of Contents

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&amp;A)

## Overview of our business

We are a global leader in the discovery, development, manufacture and commercialization of animal health medicines and vaccines, with a focus on both livestock and companion animals. For more than 60 years, as a business unit of Pfizer Inc. (Pfizer) and since 2013, as an independent public company, we have been committed to enhancing the health of animals and bringing solutions to our customers who raise and care for them.

We manage our operations through two geographic operating segments. Within each of these operating segments, we offer a diversified product portfolio for both livestock and companion animal customers in order to capitalize on local and regional trends and customer needs. Our two operating segments are the United States (U.S.) and International. See Notes to Condensed Consolidated Financial Statements—Note 17. Segment and Other Revenue Information. We directly market our products to livestock producers and veterinarians located in approximately 70 countries across North America, Europe, Africa, Asia, Australia and South America, and are a market leader in nearly all of the major regions in which we operate. Through our efforts to establish an early and direct presence in many emerging markets, such as Brazil, China and India, we believe we are the largest animal health medicines and vaccines business as measured by revenue across emerging markets as a whole. In markets where we do not have a direct commercial presence, we generally contract with distributors that provide logistics and sales and marketing support for our products.

We believe our investments in the industry's largest sales organization, including our extensive network of technical and veterinary operations specialists, our high-quality manufacturing and reliability of supply, and our long track record of developing products that meet customer needs, has led to enduring and valued relationships with our customers. Our research and development (R&D) efforts enable us to deliver innovative products to address unmet needs and evolve our product lines so they remain relevant for our customers. Additionally, our management team's focus on improving operational and cost efficiencies increases the likelihood of achieving our core growth strategies and enhancing long-term value for our shareholders.

A summary of our 2015 performance compared with the comparable 2014 period follows:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
(MILLIONS OF DOLLARS)						
Revenue	\$1,214	\$1,210	—	\$3,491	\$3,465	1
Net income attributable to Zoetis	189	166	14	317	457	(31)
Adjusted net income <sup>(a)</sup>	252	207	22	675	587	15

(a) Adjusted net income is a non-GAAP financial measure. See the "Adjusted net income" section of this MD&A for more information.

## Our operating environment

For a description of our operating environment, including factors which could materially affect our business, financial condition, or future results, see "Our Operating Environment" in the MD&A of our 2014 Annual Report on Form 10-K. Set forth below are updates to certain of the factors disclosed in our 2014 Form 10-K.

## Quarterly Variability of Financial Results

Our quarterly financial results are subject to variability related to a number of factors including but not limited to: weather patterns, herd management decisions, economic conditions, regulatory actions, competitive dynamics, disease outbreaks, product and geographic mix, timing of price increases and timing of investment decisions.

## Disease outbreaks

Sales of our livestock products could be adversely affected by the outbreak of disease carried by animals. Outbreaks of disease may reduce regional or global sales of particular animal-derived food products or result in reduced exports of such products, either due to heightened export restrictions or import prohibitions, which may reduce demand for our products. Also, the outbreak of any highly contagious disease near our main production sites could require us to immediately halt production of our products at such sites or force us to incur substantial expenses in procuring raw materials or products elsewhere. Alternatively, sales of products that treat specific disease outbreaks may increase.

For example, outbreaks of the porcine epidemic diarrhea virus (PEDv) have been occurring in the United States since 2013 and in Europe since 2014. PEDv has existed in parts of Asia for many years. It is important to note that the virus, which affects piglets, does not create a food safety issue. We are committed to supporting pork producers in understanding and controlling PEDv and we have partnered with key stakeholders, including various academic institutions such as the University of Minnesota and Iowa State University. In September 2014, the U.S. Department of Agriculture (USDA) granted us a conditional license for a vaccine to help fight PEDv. In order to receive the conditional license, we had to demonstrate the safety of the vaccine in a field study and provide a reasonable expectation of the vaccine's efficacy. We began supplying the vaccine to veterinarians and pig farmers in September 2014, and we are working to complete the efficacy and potency studies necessary to obtain full licensure in the United States from the USDA. Since first reported in the United States in 2013, PEDv has continued to spread and has now been reported in at least 34 U.S. states, as well as in Canada, Mexico, parts of South America, additional markets in Asia, including Japan, South Korea, and Taiwan; and several countries in Europe, including Spain, Germany, Italy, and France. According to recent reports,

25 |

---

Table of Contents

during 2014 PEDv impacted up to 50% of the sows in the United States, and up to one-third of the sows in Mexico. Although many of the farms that were previously infected have since returned to normal production and incidences in the United States and some Asian markets have declined, the virus continues to pose a threat to the swine industry. We currently believe the impact of PEDv on our 2015 revenue will not be significant. However, we are closely monitoring the evolution of this on-going outbreak and its impact on the swine industry and on our 2015 revenue. In addition, from December 2014 through June 2015, highly pathogenic H5 avian influenza virus infections were reported in domestic poultry, captive birds and wild birds in the United States, with a majority of confirmed infections occurring in backyard and commercial poultry flocks. The egg and turkey industry were the most impacted by this occurrence of avian influenza. USDA surveillance indicates that more than 48 million birds were affected (either infected or exposed) in at least 20 states. Although no new avian influenza infections have been detected in the United States since June 2015, the virus continues to pose a threat to the poultry industry, and is expected to return to parts of the United States during the fall and winter migrations. It is important to note that human infection with avian influenza viruses has not occurred from eating properly cooked poultry or poultry products. We are closely monitoring the developments as this situation unfolds and currently believe the impact on our 2015 global revenue will not be significant.

Foreign exchange rates

Significant portions of our revenue and costs are exposed to changes in foreign exchange rates. Our products are sold in more than 120 countries and, as a result, our revenue is influenced by changes in foreign exchange rates. For the nine months ended September 27, 2015, approximately 48% of our revenue was denominated in foreign currencies. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities. As we operate in multiple foreign currencies, including the euro, Brazilian real, Canadian dollar, Australian dollar and other currencies, changes in those currencies relative to the U.S. dollar will impact our revenue, cost of goods and expenses, and consequently, net income. Exchange rate fluctuations may also have an impact beyond our reported financial results and directly impact operations. These fluctuations may affect the ability to buy and sell our goods and services between markets impacted by significant exchange rate variances. For the nine months ended September 27, 2015, approximately 52% of our total revenue was in U.S. dollars. Our year-over-year revenue growth was unfavorably impacted by 8% from changes in foreign currency values relative to the U.S. dollar.

On February 13, 2013, the Venezuelan government devalued its currency from a rate of 4.3 to 6.3 Venezuelan bolivars per U.S. dollar. Our Venezuelan subsidiary's functional currency is the U.S. dollar because of the hyperinflationary status of the Venezuelan economy. In the first quarter of 2014, the Venezuelan government expanded its exchange mechanisms, resulting in three official rates of exchange for the Venezuelan bolivar.

On February 10, 2015, the Venezuelan government announced that they would continue to operate with a three-tier exchange rate system. In addition, they announced that the primary rate of 6.3 bolivars to the dollar would remain in place for imports that are deemed essential. A new free-floating rate (SIMADI) will replace the existing third-tier rate (SICAD II). As of September 27, 2015, the Venezuelan bolivar to U.S. dollar exchange rates were the CENCOEX rate of 6.3; the SICAD I rate of 13.5; and the SIMADI rate of 198.7. We continue to use the CENCOEX rate of 6.3 to report our Venezuela financial position, results of operations and cash flows.

We cannot predict whether there will be further devaluation of the Venezuelan bolivar or whether our use of the 6.3 rate will continue to be supported by evolving facts and circumstances.

We may experience adverse impacts to earnings as our revenue, costs and expenses may be translated into U.S. dollars at lower rates. As of August 23, 2015, we had net monetary assets denominated in local currency of \$82 million (including \$86 million in cash) in Venezuela, and other consolidated entities had receivables from our Venezuela business of \$51 million. At August 23, 2015, we had approximately \$41 million of Venezuelan bolivar awaiting government approval for settlement. For the nine months ended August 23, 2015, our revenue from the Venezuelan market was approximately \$57 million.

In February 2014, the Venezuelan government issued a Law on Fair Pricing, establishing a maximum profit margin of 30%. At the time of its issuance, there was uncertainty as to how the law would be interpreted and applied. The Venezuelan government also recently issued new regulations relating to the publication of these fair prices to



consumers. While we believe we are currently fully compliant with this new law, it is uncertain how this law may be interpreted and enforced in the future.

The actions of the Venezuelan government described above relating to currency and to the interpretation and enforcement of the Law on Fair Pricing and associated regulations, as well as other potential actions by the Venezuelan government in response to economic uncertainties could impact the recoverability of our investment in Venezuela, which could result in a charge and, under extreme circumstances, could impact our ability to continue to operate in the country in the same manner as we have historically.

Based on all of the factors noted above, in the second quarter of 2015, we decided to decrease our activity in Venezuela in 2015. As a result, we expect our revenue for the year ended November 30, 2015, to decline, as compared with \$77 million for the year ended November 30, 2014.

#### Certain Regulatory Matters

Our manufacturing facilities are subject to periodic inspections by regulatory agencies. An inspector may report conditions or practices that indicate possible violations of regulatory requirements. The U.S. Food and Drug Administration (FDA) provides notice of these observations in a Form 483. In January 2015, the FDA conducted inspections at three of our manufacturing facilities, after which the FDA issued Form 483s to the company in connection with two of these inspections. We responded to the FDA observations and met with the Center for Veterinary Medicines at the FDA to address their concerns. The issues raised during these inspections have been resolved to the FDA's satisfaction and are now closed. In October 2014, we received a letter from the USDA's Center for Veterinary Biologicals (CVB) requesting that we meet with the CVB to discuss compliance issues at certain of our U.S. sites that manufacture biological products. We met with the CVB to discuss the CVB's

Table of Contents

specific concerns and presented a plan for certain corrective and preventive actions. In 2015, we have had two follow-up meetings with the USDA to review our progress on the agreed to plan.

Recent developments

On November 2, 2015, we announced an agreement to purchase PHARMAQ, the global leader in vaccines and innovation for health products in aquaculture, based in Oslo, Norway, for \$765 million (adjusted to reflect working capital and net indebtedness as of the closing date). PHARMAQ is the market leader in vaccines for farmed fish. The company generated revenue of approximately \$80 million in 2014 and markets its products in the major fish-producing markets. We expect to complete the acquisition in the fourth quarter of 2015 and we intend on drawing on our revolving credit facility to finance the transaction.

Also on November 2, 2015, we amended a financial covenant in our existing \$1 billion revolving credit facility mentioned above to increase the existing maximum total leverage ratio from 3.50:1 to 4.25:1 only upon entering into a material acquisition, as defined. The amended ratio extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. See Note 9A. Financial Instruments—Debt: Credit Facilities for additional information regarding the existing facility and leverage ratio.

Comparability of historical results and our relationship with Pfizer

Our historical expenses are not necessarily indicative of the expenses we may incur in the future as we continue to stand up as an independent public company. With respect to support functions, for example, our historical combined financial statements prior to the IPO have included expense allocations for certain support functions that were provided on a centralized basis within Pfizer, such as expenses for business technology, facilities, legal, finance, human resources, and, to a lesser extent, business development, public affairs and procurement, among others. At the time of the IPO, we entered into a transitional services agreement with Pfizer whereby Pfizer agreed to provide us with various corporate support services. In addition, we entered into a master manufacturing and supply agreement with Pfizer, whereby we and Pfizer agreed to manufacture and supply products to each other. We are also incurring other costs to replace the services and resources that will not be provided by Pfizer. As an independent public company, our total costs related to such support functions may differ from the costs charged under these agreements with Pfizer, or that were historically allocated to us from Pfizer. For additional information regarding our ongoing agreements with Pfizer, see Note 19. Transactions and Agreements with Pfizer in our 2014 Annual Report on Form 10-K.

We have also incurred certain nonrecurring costs related to becoming an independent public company, including new branding (which includes changes to the manufacturing process for required new packaging), the creation of standalone systems and infrastructure, site separation and certain legal registration and patent assignment costs.

Public company expenses

As a result of the IPO, we became subject to the reporting requirements of the Exchange Act and the Sarbanes-Oxley Act. We have established additional procedures and practices as an independent public company. As a result, we are incurring additional costs, including, but not limited to, internal audit, investor relations, stock administration and regulatory compliance costs.

Recent acquisitions and government-mandated divestitures

The assets, liabilities, operating results and cash flows of acquired businesses are included in our results commencing from their respective acquisition dates.

On February 10, 2015, we completed the purchase of certain assets of Abbott Animal Health, a subsidiary of Abbott Laboratories. For additional information, see Note 5. Acquisitions and Divestitures - Acquisition of Abbott Animal Health.

## Analysis of the condensed consolidated statements of income

The following discussion and analysis of our statements of income should be read along with our condensed consolidated financial statements and the notes thereto included elsewhere in Part I, Item 1 of this Quarterly Report on Form 10-Q.

(MILLIONS OF DOLLARS)	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
Revenue	\$1,214	\$1,210	—	\$3,491	\$3,465	1
Costs and expenses:						
Cost of sales <sup>(a)</sup>	421	434	(3 )	1,242	1,226	1
% of revenue	35	% 36	%	36	% 35	%
Selling, general and administrative expenses <sup>(a)</sup>	374	394	(5 )	1,107	1,146	(3 )
% of revenue	31	% 33	%	32	% 33	%
Research and development expenses <sup>(a)</sup>	91	93	(2 )	255	272	(6 )
% of revenue	7	% 8	%	7	% 8	%
Amortization of intangible assets <sup>(a)</sup>	15	16	(6 )	45	46	(2 )
Restructuring charges and certain acquisition-related costs	13	2	*	280	10	*
Interest expense, net of capitalized interest	29	29	—	86	87	(1 )
Other (income)/deductions—net	(2 )	4	*	—	13	(100 )
Income before provision for taxes on income	273	238	15	476	665	(28 )
% of revenue	22	% 20	%	14	% 19	%
Provision for taxes on income	83	71	17	157	204	(23 )
Effective tax rate	30.4	% 29.8	%	33.0	% 30.7	%
Net income before allocation to noncontrolling interests	190	167	14	319	461	(31 )
Less: Net income attributable to noncontrolling interests	1	1	—	2	4	(50 )
Net income attributable to Zoetis	\$189	\$166	14	\$317	\$457	(31 )
% of revenue	16	% 14	%	9	% 13	%

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Amortization expense related to finite-lived acquired intangible assets that contribute to our ability to sell, manufacture, research, market and distribute products, compounds and intellectual property is included in Amortization of intangible assets as these intangible assets benefit multiple business functions.

(a) Amortization expense related to acquired intangible assets that are associated with a single function is included in Cost of sales, Selling, general and administrative expenses or Research and development expenses, as appropriate.

## Revenue

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Total revenue increased by \$4 million in the third quarter of 2015 compared with the third quarter of 2014, reflecting higher operational revenue of \$114 million, or 9%, comprised of 6% volume increases and 3% price increases.

Operational revenue growth is defined as revenue growth excluding the impact of foreign exchange. Operational revenue growth was driven by increased revenue in the U.S. segment, in addition to solid performance from international markets, particularly Japan, Brazil, China, and the United Kingdom. Total livestock sales increased 5% operationally, driven primarily by growth in cattle and swine due to the timing of seasonal buying patterns. The timing

of seasonal buying patterns can fluctuate from quarter to quarter due to seasonal weather and herd movements. Total companion animal sales increased 18% operationally, driven by the addition of sales from the acquisition of certain assets of Abbott Animal Health, as well as the performance of Apoquel® and other key brands.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Total revenue increased by \$26 million in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, reflecting higher operational revenue of \$300 million, or 9%, comprised of 6% volume increases and 3% price increases. Operational revenue growth was driven by increased revenue in the U.S. segment, in addition to strong performance from international markets, particularly Brazil, China, the United Kingdom and Japan. Total livestock sales increased 7% operationally, driven by growth across all of our key species, particularly due to new product launches and favorable market conditions in cattle and swine. Total companion animal sales increased 12% operationally, driven by the addition of sales from the acquisition of certain assets of Abbott Animal Health, as well as the performance of Apoquel® and other key brands.

Table of Contents

## Costs and Expenses

## Cost of sales

(MILLIONS OF DOLLARS)	Three Months Ended			Nine Months Ended		
	September	September	%	September	September	%
	27,	28,		27,	28,	
	2015	2014	Change	2015	2014	Change
Cost of sales	\$421	\$434	(3 )	\$1,242	\$1,226	1
% of revenue	34.7	% 35.9	%	35.6	% 35.4	%

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Cost of sales decreased by \$13 million, or 3%, in the third quarter of 2015 compared with the third quarter of 2014, primarily as a result of:

favorable foreign exchange;

partially offset by:

an increase in sales volume and unfavorable product mix;

higher global manufacturing and supply costs; and

consulting charges relating to our operational efficiency initiative.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Cost of sales increased by \$16 million, or 1%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, primarily as a result of:

an increase in sales volume and unfavorable product mix;

higher global manufacturing and supply costs; and

consulting charges relating to our operational efficiency initiative;

partially offset by:

favorable foreign exchange.

## Selling, general and administrative expenses

(MILLIONS OF DOLLARS)	Three Months Ended			Nine Months Ended		
	September	September	%	September	September	%
	27,	28,		27,	28,	
	2015	2014	Change	2015	2014	Change
Selling, general and administrative expenses	\$374	\$394	(5 )	\$1,107	\$1,146	(3 )
% of revenue	31	% 33	%	32	% 33	%

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Selling, general & administrative (SG&A) expenses decreased by \$20 million, or 5%, in the third quarter of 2015 compared with the third quarter of 2014, primarily as a result of:

favorable foreign exchange; and

a reduction in marketing and other spending driven by our operational efficiency initiative;

partially offset by:

consulting charges relating to our operational efficiency initiative;

higher costs associated with our enabling functions, including higher business technology costs; and

an increase in bad debt expense.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Selling, general & administrative (SG&A) expenses decreased by \$39 million, or 3%, in the nine months ended September 27, 2015 compared with the nine months ended September 28, 2014, primarily as a result of:

favorable foreign exchange; and

a reduction in marketing and other spending driven by our operational efficiency initiative;

partially offset by:

29 |

---

Table of Contents

consulting charges relating to our operational efficiency initiative;  
 higher costs associated with our enabling functions, including higher business technology and facilities costs; and  
 an increase in bad debt expense.

Research and development expenses

	Three Months Ended			Nine Months Ended		
	September	September	%	September	September	%
	27,	28,		27,	28,	
(MILLIONS OF DOLLARS)	2015	2014	Change	2015	2014	Change
Research and development expenses	\$91	\$93	(2 )	\$255	\$272	(6 )
% of revenue	7	% 8	%	7	% 8	%

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

R&D expenses decreased by \$2 million, or 2%, in the third quarter of 2015 compared with the third quarter of 2014, primarily as a result of:

favorable foreign exchange; and

a reduction in headcount related expenses driven by our operational efficiency initiative;

partially offset by:

higher spend due to timing of portfolio driven activities.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

R&D expenses decreased by \$17 million, or 6%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, primarily as a result of:

favorable foreign exchange; and

a reduction in spend driven by our operational efficiency initiative.

Amortization of intangible assets

	Three Months Ended			Nine Months Ended		
	September	September	%	September	September	%
	27,	28,		27,	28,	
(MILLIONS OF DOLLARS)	2015	2014	Change	2015	2014	Change
Amortization of intangible assets	\$15	\$16	(6 )	\$45	\$46	(2 )

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Amortization of intangible assets decreased by \$1 million, or 6%, in the third quarter of 2015 compared with the third quarter of 2014.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Amortization of intangible assets decreased by \$1 million, or 2%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014.

Restructuring charges and certain acquisition-related costs

	Three Months Ended			Nine Months Ended		
	September	September	%	September	September	%
	27,	28,		27,	28,	
(MILLIONS OF DOLLARS)	2015	2014	Change	2015	2014	Change
Restructuring charges and certain acquisition-related costs	\$13	\$2	*	\$280	\$10	*

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

On May 5, 2015, we announced a comprehensive operational efficiency program, which is incremental to the supply network strategy that was previously announced. These program's actions are focused on reducing complexity in our product portfolios through the elimination of approximately 5,000 product SKUs, changing our selling approach in certain markets and reducing our presence in certain countries, as well as planning to sell or exit ten manufacturing

sites over the long term. We also plan to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing commercial activities and operating more efficiently as a result of less internal complexity and more standardization of processes.

The implementation of our operational efficiency initiative and supply network strategy is expected to reduce revenue and gross profit by 2017 by approximately \$280 million and \$100 million, respectively. Additionally, we expect these actions to generate approximately \$300 million in annual cost savings by 2017. As part of this initiative, we expect to reduce certain positions through divestitures, normal attrition and

30 |

---



Table of Contents

involuntary terminations by approximately 2,000 to 2,500, subject to consultations with works councils and unions in certain countries, primarily over the next 15 months. We expect these actions to result in approximately \$420 million to \$480 million in pre-tax charges, excluding non-cash items.

Our acquisition-related costs are primarily related to restructuring charges for employees, assets and activities that will not continue in the future, as well as integration costs. The majority of these net restructuring charges are related to termination costs, but we may also exit distributor and other contracts and perform facility rationalization efforts. Our integration costs are generally comprised of consulting costs related to the integration of systems and processes, as well as product transfer costs.

For additional information regarding restructuring charges and acquisition-related costs, see Notes to Condensed Consolidated Financial Statements—Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Restructuring charges and certain acquisition-related costs increased by \$11 million in the third quarter of 2015 compared with the third quarter of 2014, primarily as a result of asset impairment charges. In the third quarter of 2015, we recorded asset impairment charges of \$8 million relating to the operational efficiency initiative. In the third quarter of 2014, we recorded restructuring charges of \$1 million related to employee severance costs in Europe.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Restructuring charges and certain acquisition-related costs increased by \$270 million in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, as a result of an increase in employee termination costs and asset impairment charges. For the nine months ended September 27, 2015, we recorded restructuring charges of \$261 million relating to the operational efficiency initiative, consisting of employee termination costs of \$228 million and asset impairment charges of \$33 million, and restructuring charges of \$10 million relating to the supply network strategy, consisting of employee termination costs of \$9 million and asset impairment charges of \$1 million. In the nine months ended September 28, 2014, we recorded restructuring charges of \$6 million related to employee severance costs in Europe as a result of initiatives to reduce costs and better align our organizational structure.

Interest expense, net of capitalized interest

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
(MILLIONS OF DOLLARS)						
Interest expense, net of capitalized interest	\$29	\$29	—	\$86	\$87	(1 )

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Interest expense, net of capitalized interest, was flat in the third quarter of 2015 compared with the third quarter of 2014.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Interest expense, net of capitalized interest, decreased by \$1 million, or 1%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014.

Other (income)/deductions—net

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
(MILLIONS OF DOLLARS)						
Other (income)/deductions—net	\$(2 )	\$4	*	\$—	\$13	(100 )

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

The change in Other (income)/deductions—net reflects a favorable impact of \$6 million on income attributable to Zoetis in the third quarter of 2015 compared with the third quarter of 2014, primarily due to:

- an impairment of IPR&D assets in 2014 related to a pharmaceutical product for dogs acquired with the FDAH acquisition in 2009.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

The change in Other (income)/deductions—net reflects a favorable impact of \$13 million on income attributable to Zoetis in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, primarily due to:

- lower charges for legal and other matters as a result of a commercial settlement of \$13 million in Mexico in 2014;
- lower foreign currency losses in 2015 as a result of the depreciation of the Argentine peso in the first quarter of 2014;
- and
- a pension plan settlement charge incurred in the first quarter of 2014 related to the sale of a manufacturing plant;

Table of Contents

partially offset by:

- an impairment of IPR&D assets related to the termination of a canine oncology project;
- charges related to inventory losses as a result of weather damage to storage facilities in Brazil and Australia; and
- a net gain on the sale of land by our Taiwan joint venture in 2014.

Provision for taxes on income

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
(MILLIONS OF DOLLARS)						
Provision for taxes on income	\$83	\$71	17	\$157	\$204	(23 )
Effective tax rate	30.4	% 29.8	%	33.0	% 30.7	%

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

The effective tax rate was 30.4% for the third quarter of 2015, compared with 29.8% for the third quarter of 2014. The higher effective tax rate for the third quarter of 2015 was primarily attributable to changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from (i) operations and (ii) restructuring charges related to the operational efficiency initiative and supply network strategy, as well as repatriation costs.

The impact of the incentive tax rulings in Belgium, effective December 1, 2012 through 2017, and Singapore, effective October 29, 2012 through 2016, continue to be a component of the 2015 effective tax rate.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

The effective tax rate was 33.0% for the nine months ended September 27, 2015, compared with 30.7% for the nine months ended September 28, 2014. The higher effective tax rate for the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, was primarily attributable to:

changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from (i) operations and (ii) restructuring charges related to the operational efficiency initiative and supply network strategy, as well as repatriation costs; and

• a valuation allowance of \$3 million recorded in the second quarter of 2015;

partially offset by:

• a \$9 million discrete tax benefit recorded in the first quarter of 2015 related to a revaluation of deferred taxes as a result of a change in tax rates; and

• a \$6 million discrete tax benefit recorded in the second quarter of 2015 related to prior period tax adjustments.

## Operating Segment Results

In the second quarter of 2015, we changed our segment reporting structure to reflect the way management makes operating decisions. We consolidated our prior Europe/Africa/Middle East (EuAfME), Canada/Latin America (CLAR) and Asia/Pacific (APAC) operating segments into one operating segment. As a result, the company's new segment reporting structure consists of two reportable segments: the United States and International. We also reclassified certain costs that are not allocated to our operating segments. There has been no change in our total condensed consolidated financial condition or results of operations previously reported as a result of the change in our segment structure. The prior period presentation has been revised to reflect the new segment reporting structure. We believe that it is important to not only understand overall revenue and earnings growth, but also "operational growth." Operational growth is defined as revenue or earnings growth excluding the impact of foreign exchange. On a global basis, the mix of revenue between livestock and companion animal products was as follows:

(MILLIONS OF DOLLARS)	Three Months Ended		% Change		
	September 27, 2015	September 28, 2014	Total	Related to Foreign Exchange	Operational
U.S.					
Livestock	\$348	\$308	13	—	13
Companion animal	284	224	27	—	27
	632	532	19	—	19
International					
Livestock	402	482	(17)	(17)	—
Companion animal	167	184	(9)	(16)	7
	569	666	(15)	(17)	2
Total					
Livestock	750	790	(5)	(10)	5
Companion animal	451	408	11	(7)	18
Contract Manufacturing	13	12	8	(5)	13
	\$1,214	\$1,210	—	(9)	9

Certain amounts and percentages may reflect rounding adjustments.

(MILLIONS OF DOLLARS)	Nine Months Ended		% Change		
	September 27, 2015	September 28, 2014	Total	Related to Foreign Exchange	Operational
U.S.					
Livestock	\$903	\$795	14	—	14
Companion animal	789	675	17	—	17
	1,692	1,470	15	—	15
International					
Livestock	1,252	1,404	(11)	(14)	3
Companion animal	510	552	(8)	(15)	7
	1,762	1,956	(10)	(14)	4
Total					
Livestock	2,155	2,199	(2)	(9)	7
Companion animal	1,299	1,227	6	(6)	12
Contract Manufacturing	37	39	(5)	(7)	2

Edgar Filing: Zoetis Inc. - Form 10-Q

\$3,491      \$3,465      1      (8      ) 9

Certain amounts and percentages may reflect rounding adjustments.

33 |

---

Earnings by segment and the operational and foreign exchange changes versus the comparable prior year period are as follows:

(MILLIONS OF DOLLARS)	Three Months Ended		% Change		
	September 27, 2015	September 28, 2014	Total	Related to Foreign	
				Exchange	Operational
U.S.					
Revenue	\$632	\$532	19	—	19
Cost of Sales	147	126	17	—	17
Gross Profit	485	406	19		19
Gross Margin	76.7	% 76.3	%	—	
Operating Expenses	100	93	8	—	8
Other (income)/deductions	(1	) —	*	—	*
U.S. Earnings	386	313	23	—	23
International					
Revenue	569	666	(15	) (17	) 2
Cost of Sales	209	241	(13	) (13	) —
Gross Profit	360	425	(15	) (18	) 3
Gross Margin	63.3	% 63.8	%		
Operating Expenses	137	168	(18	) (16	) (2
Other (income)/deductions	4	2	100	*	*
International Earnings	219	255	(14	) (21	) 7
Total operating segments	605	568	7	(9	) 16
Other business activities	(73	) (76	) (4	)	
Reconciling Items:					
Corporate	(138	) (142	) (3	)	
Purchase accounting adjustments	(13	) (13	) —		
Acquisition-related costs	(6	) (1	) *		
Certain significant items	(46	) (38	) 21		
Other unallocated	(56	) (60	) (7	)	
Income before provision for taxes on income	\$273	\$238	15		

\* Calculation not meaningful

Certain amounts and percentages may reflect rounding adjustments.

Edgar Filing: Zoetis Inc. - Form 10-Q

(MILLIONS OF DOLLARS)	Nine Months Ended		% Change		
	September 27, 2015	September 28, 2014	Total	Related to Foreign Exchange    Operational	
<b>U.S.</b>					
Revenue	\$1,692	\$1,470	15	—	15
Cost of Sales	399	343	16	—	16
Gross Profit	1,293	1,127	15	—	15
Gross Margin	76.4	% 76.7	%		
Operating Expenses	274	278	(1	) —	(1
Other (income)/deductions	(1	) —	—	—	—
U.S. Earnings	1,020	849	20	—	20
<b>International</b>					
Revenue	1,762	1,956	(10	) (14	) 4
Cost of Sales	638	701	(9	) (11	) 2
Gross Profit	1,124	1,255	(10	) (15	) 5
Gross Margin	63.8	% 64.2	%		
Operating Expenses	423	490	(14	) (14	) —
Other (income)/deductions	10	5	100	60	40
International Earnings	691	760	(9	) (17	) 8
Total operating segments	1,711	1,609	6	(8	) 14
Other business activities	(208	) (224	) (7	)	
<b>Reconciling Items:</b>					
Corporate	(392	) (389	) 1		
Purchase accounting adjustments	(41	) (38	) 8		
Acquisition-related costs	(11	) (5	) *		
Certain significant items	(406	) (127	) *		
Other unallocated	(177	) (161	) 10		
Income before provision for taxes on income	\$476	\$665	(28	)	

\*Calculation not meaningful

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

U.S. operating segment

U.S. segment revenue increased by \$100 million, or 19%, in the third quarter of 2015 compared with the third quarter of 2014, of which approximately \$40 million resulted from growth in livestock products and approximately \$60 million resulted from growth in companion animal products.

Livestock revenue growth was driven by increased sales in cattle and swine. Sales of both cattle and swine products grew as a result of the timing of seasonal buying patterns.

Companion animal revenue growth was driven by the addition of products acquired from Abbott Animal Health, as well as the solid performance of Apoquel® and other key brands.

U.S. segment earnings increased by \$73 million, or 23%, in the third quarter of 2015 compared with the third quarter of 2014 due to strong revenue growth and lower operating expenses.

International operating segment

International segment revenue decreased by \$97 million, or 15%, in the third quarter of 2015 compared with the third quarter of 2014. Operational revenue increased \$12 million, or 2%, reflecting a decline of approximately \$2 million in livestock products and growth of approximately \$14 million in companion animal products.

Livestock decline was driven primarily by lower sales in Venezuela associated with our reduced business activities in this country. Additional livestock declines were driven by lower sales in France due to higher sales of anti-infectives in the prior year as customers sought to buy products ahead of more restrictive legislative changes. These declines were partially offset by growth in swine in China and cattle in Brazil and Australia.

35 |

---



Companion animal revenue growth resulted from increased sales of Apoquel<sup>®</sup>, the addition of products acquired from Abbott Animal Health, and the non-recurrence of a prior year inventory buyback related to the termination of a distributor agreement in Japan.

Additionally, segment revenue was unfavorably impacted by foreign exchange, which decreased revenue by approximately \$109 million, or 17%, primarily driven by the depreciation of the euro and the Brazilian real. International segment earnings decreased by \$36 million, or 14%, in the third quarter of 2015 compared with the third quarter of 2014. Operational earnings growth was \$19 million, or 7%, primarily due to higher revenue and lower operating expenses.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

U.S. operating segment

U.S. segment revenue increased by \$222 million, or 15%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, of which approximately \$108 million resulted from growth in livestock products and approximately \$114 million resulted from growth in companion animal products.

Livestock revenue growth was driven by increased sales in cattle, swine and poultry. Sales of cattle products grew across multiple categories, including premium brands, as a result of timing of seasonal buying patterns and favorable market conditions. Cattle also benefited from new product launches. Sales of swine products also increased due to the timing of seasonal buying patterns, new products, and the continued recovery in the pig population following the PEDv outbreak. Growth in sales of poultry products was driven by the re-introduction of a medicated feed additive. Companion animal revenue growth was driven by the addition of products acquired from Abbott Animal Health, as well as the solid performance of Apoquel<sup>®</sup>. This growth was partially offset by competitive pressure in pain management products.

U.S. segment earnings increased by \$171 million, or 20%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, due to strong revenue growth and lower expenses, partially offset by unfavorable product mix.

International operating segment

International segment revenue decreased by \$194 million, or 10%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014. Operational revenue increased by \$77 million, or 4%, reflecting growth of approximately \$39 million in livestock products and growth of approximately \$38 million in companion animal products.

Livestock revenue growth was driven by higher sales of swine and cattle products, partially offset by lower sales of poultry products. The performance of our portfolio in China and other Asian markets helped drive increased sales of swine products, which are benefiting from favorable market conditions and higher producer profitability. Continued favorable market conditions and new product launches in Brazil drove cattle growth, which was partially offset by the impact of the France AIF legislation change last year. The poultry sales decline was driven by lower medicated feed additive sales in certain Latin American and Eastern European markets.

Companion animal revenue growth was favorably impacted by the addition of products acquired from Abbott Animal Health. In addition, growth resulted from increased sales of Apoquel<sup>®</sup>, as well as strong vaccine and parasiticide sales in China.

Additionally, segment revenue was unfavorably impacted by foreign exchange, which decreased revenue by approximately \$271 million, or 14%, primarily driven by the depreciation of the euro and Brazilian real.

International segment earnings decreased by \$69 million, or 9%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014. Operational earnings growth was \$63 million, or 8%, primarily due to higher gross profit margins.

Other business activities

Other business activities includes our Client Supply Services (CSS) contract manufacturing results, as well as expenses associated with our dedicated veterinary medicine research and development organization, research alliances, U.S. regulatory affairs and other operations focused on the development of our products. Other R&D-related costs associated with non-U.S. market and regulatory activities are generally included in the respective regional segment.

Edgar Filing: Zoetis Inc. - Form 10-Q

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Other business activities net loss decreased by \$3 million, or 4%, in the third quarter of 2015 compared with the third quarter of 2014, reflecting favorable foreign exchange and lower compensation related expenses partially offset by higher R&D spending due to timing of portfolio driven activities.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Other business activities net loss decreased by \$16 million, or 7%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, reflecting favorable foreign exchange, and a decrease in R&D spending driven by our operational efficiency initiative.

#### Reconciling items

Reconciling items include certain costs that are not allocated to our operating segments results, such as costs associated with the following:

Corporate, which includes certain costs associated with business technology, facilities, legal, finance, human resources, business development and communications, among others. These costs also include certain compensation costs and other miscellaneous operating expenses that are not charged to our operating segments, as well as interest income and expense;

Certain transactions and events such as (i) Purchase accounting adjustments, which includes expenses associated with the amortization of fair value adjustments to inventory, intangible assets, and property, plant and equipment; (ii) Acquisition-related activities, which includes costs for restructuring and integration; and (iii) Certain significant items, which includes non-acquisition-related restructuring charges, certain asset impairment charges, stand-up costs, certain legal and commercial settlements, and costs associated with cost reduction/productivity initiatives; and Other unallocated, which includes (i) certain overhead expenses associated with our global manufacturing operations not charged to our operating segments; (ii) certain costs associated with business technology and finance that specifically support our global manufacturing operations; (iii) certain supply chain and global logistics costs; and (iv) procurement costs.

Three months ended September 27, 2015 vs. three months ended September 28, 2014

Corporate losses decreased by \$4 million, or 3%, in the third quarter of 2015 compared with the third quarter of 2014, primarily due to the favorable impact of foreign exchange, partially offset by higher costs associated with our enabling functions, including higher business technology costs and higher depreciation on assets recently placed in service.

Other unallocated losses declined by \$4 million, or 7%, in the third quarter of 2015 compared with the third quarter of 2014, primarily due to favorable foreign exchange, partially offset by higher global manufacturing and supply costs. See Notes to Condensed Consolidated Financial Statements—Note 17. Segment and Other Revenue Information for further information.

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Corporate losses increased by \$3 million, or 1%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, primarily due to additional costs associated with the build-up of our enabling functions post-separation from Pfizer, including higher business technology costs and higher depreciation on assets recently placed in service, as well as the non-recurrence of Zoetis' share of a prior year gain on the sale of land, partially offset by the favorable impact of foreign exchange.

Other unallocated losses increased by \$16 million, or 10%, in the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, primarily due to higher global manufacturing and supply costs, partially offset by favorable foreign exchange.

See Notes to Condensed Consolidated Financial Statements—Note 17. Segment and Other Revenue Information for further information.

#### Adjusted net income

General description of adjusted net income (a non-GAAP financial measure)

Adjusted net income is an alternative view of performance used by management, and we believe that investors' understanding of our performance is enhanced by disclosing this performance measure. We report adjusted net income to portray the results of our major operations, the discovery, development, manufacture and commercialization of our products, prior to considering certain income statement elements. We have defined adjusted net income as net income attributable to Zoetis before the impact of purchase accounting adjustments, acquisition-related costs and certain significant items. The adjusted net income measure is not, and should not be viewed as, a substitute for U.S. GAAP reported net income attributable to Zoetis.

The adjusted net income measure is an important internal measurement for us. We measure our overall performance on this basis in conjunction with other performance metrics. The following are examples of how the adjusted net income measure is utilized:

senior management receives a monthly analysis of our operating results that is prepared on an adjusted net income basis;

our annual budgets are prepared on an adjusted net income basis; and  
other goal setting and performance measurements.

Despite the importance of this measure to management in goal setting and performance measurement, adjusted net income is a non-GAAP financial measure that has no standardized meaning prescribed by U.S. GAAP and, therefore, has limits in its usefulness to investors. Because of its non-standardized definition, adjusted net income, unlike U.S. GAAP net income, may not be comparable to the calculation of similar measures of other companies. Adjusted net income is presented to permit investors to more fully understand how management assesses performance.

We also recognize that, as an internal measure of performance, the adjusted net income measure has limitations, and we do not restrict our performance management process solely to this metric. A limitation of the adjusted net income measure is that it provides a view of our operations without including all events during a period, such as the effects of an acquisition or amortization of purchased intangibles, and does not provide a comparable view of our performance to other companies. We also use other specifically tailored tools designed to achieve the highest levels of performance.

37 |

---

## Table of Contents

### Purchase accounting adjustments

Adjusted net income is calculated prior to considering certain significant purchase accounting impacts that result from business combinations and net asset acquisitions. These impacts, primarily associated with the acquisition of certain assets of Abbott Animal Health (acquired in 2015), Pharmacia Animal Health business (acquired in 2003), Fort Dodge Animal Health (FDAH) (acquired in 2009) and King Animal Health (KAH) (acquired in 2011), include amortization related to the increase in fair value of the acquired finite-lived intangible assets and depreciation related to the increase/decrease to fair value of the acquired fixed assets. Therefore, the adjusted net income measure includes the revenue earned upon the sale of the acquired products without considering the aforementioned significant charges. While certain purchase accounting adjustments can occur through 20 or more years, this presentation provides an alternative view of our performance that is used by management to internally assess business performance. We believe the elimination of amortization attributable to acquired intangible assets provides management and investors an alternative view of our business results by providing a degree of parity to internally developed intangible assets for which R&D costs previously have been expensed.

A completely accurate comparison of internally developed intangible assets and acquired intangible assets cannot be achieved through adjusted net income. These components of adjusted net income are derived solely from the impact of the items listed above. We have not factored in the impact of any other differences in experience that might have occurred if we had discovered and developed those intangible assets on our own, and this approach does not intend to be representative of the results that would have occurred in those circumstances. For example, our R&D costs in total, and in the periods presented, may have been different; our speed to commercialization and resulting revenue, if any, may have been different; or our costs to manufacture may have been different. In addition, our marketing efforts may have been received differently by our customers. As such, in total, there can be no assurance that our adjusted net income amounts would have been the same as presented had we discovered and developed the acquired intangible assets.

### Acquisition-related costs

Adjusted net income is calculated prior to considering transaction, integration, restructuring and additional depreciation costs associated with significant business combinations or net-asset acquisitions because these costs are unique to each transaction and represent costs that were incurred to restructure and integrate certain businesses as a result of the acquisition decision. We have made no adjustments for the resulting synergies.

We believe that viewing income prior to considering these charges provides investors with a useful additional perspective because the significant costs incurred in a business combination result primarily from the need to eliminate duplicate assets, activities or employees—a natural result of acquiring a fully integrated set of activities. For this reason, we believe that the costs incurred to convert disparate systems, to close duplicative facilities or to eliminate duplicate positions (for example, in the context of a business combination) can be viewed differently from those costs incurred in the ordinary course of business.

The integration and restructuring costs associated with a business combination may occur over several years, with the more significant impacts ending within three years of the transaction. Because of the need for certain external approvals for some actions, the span of time needed to achieve certain restructuring and integration activities can be lengthy. For example, due to the regulated nature of the animal health medicines and vaccines business, the closure of excess facilities can take several years, as all manufacturing changes are subject to extensive validation and testing and must be approved by the FDA and/or other regulatory authorities.

### Certain significant items

Adjusted net income is calculated prior to considering certain significant items. Certain significant items represents substantive, unusual items that are evaluated on an individual basis. Such evaluation considers both the quantitative and the qualitative aspect of their unusual nature. Unusual, in this context, may represent items that are not part of our ongoing business; items that, either as a result of their nature or size, we would not expect to occur as part of our normal business on a regular basis; items that would be nonrecurring; or items that relate to products that we no longer sell. While not all-inclusive, examples of items that could be included as certain significant items would be costs related to becoming an independent public company; a major non-acquisition-related restructuring charge and associated implementation costs for a program that is specific in nature with a defined term, such as those related to

our non-acquisition-related cost-reduction and productivity initiatives; amounts related to disposals of products or facilities that do not qualify as discontinued operations as defined by U.S. GAAP; certain intangible asset impairments; adjustments related to the resolution of certain tax positions; the impact of adopting certain significant, event-driven tax legislation; or charges related to legal matters. See Notes to Condensed Consolidated Financial Statements—Note 16. Commitments and Contingencies. Our normal, ongoing defense costs or settlements of and accruals on legal matters made in the normal course of our business would not be considered certain significant items.

38 |

---

Table of Contents

## Reconciliation

A reconciliation of net income attributable to Zoetis, as reported under U.S. GAAP, to adjusted net income follows:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
(MILLIONS OF DOLLARS)						
GAAP reported net income attributable to Zoetis	\$ 189	\$ 166	14	\$ 317	\$ 457	(31 )
Purchase accounting adjustments—net of tax	9	9	—	27	25	8
Acquisition-related costs—net of tax	6	—	*	13	3	*
Certain significant items—net of tax	48	32	50	318	102	*
Non-GAAP adjusted net income <sup>(a)</sup>	\$ 252	\$ 207	22	\$ 675	\$ 587	15

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

The effective tax rate on adjusted pretax income is 25.1% and 28.3% for the third quarter of 2015 and 2014, respectively, and 27.5% and 29.2% for the first nine months of 2015 and 2014, respectively. The lower effective tax rate in the third quarter of 2015 compared with the third quarter of 2014 was primarily attributable to changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs. The lower effective tax rate for the nine months ended September 27, 2015, compared with the nine months ended September 28, 2014, was primarily attributable to a \$4 million discrete tax benefit recorded in the first quarter of 2015 related to prior period deferred tax adjustments, offset by the recording of an \$8 million discrete tax expense during the first quarter of 2014 related to a prior period intercompany inventory adjustment, and changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs.

A reconciliation of reported diluted earnings per share (EPS), as reported under U.S. GAAP, to non-GAAP adjusted diluted EPS follows:

	Three Months Ended			Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change	September 27, 2015	September 28, 2014	% Change
Earnings per share—diluted <sup>(a)(b)</sup> :						
GAAP reported EPS attributable to Zoetis—diluted	\$ 0.38	\$ 0.33	15	\$ 0.63	\$ 0.91	(31 )
Purchase accounting adjustments—net of tax	0.02	0.02	—	0.05	0.05	—
Acquisition-related costs—net of tax	0.01	—	*	0.03	0.01	*
Certain significant items—net of tax	0.09	0.06	50	0.63	0.20	*
Non-GAAP adjusted EPS—diluted	\$ 0.50	\$ 0.41	22	\$ 1.34	\$ 1.17	15

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

<sup>(a)</sup> EPS amounts may not add due to rounding.

<sup>(b)</sup> Diluted earnings per share was computed using the weighted-average common shares outstanding during the period plus the common stock equivalents related to stock options, RSUs, PSUs and DSUs.

Adjusted net income includes the following charges for each of the periods presented:

Three Months Ended		Nine Months Ended	
September 27,	September 28,	September 27,	September 28,

Edgar Filing: Zoetis Inc. - Form 10-Q

(MILLIONS OF DOLLARS)	2015	2014	2015	2014
Interest expense, net of capitalized interest	\$29	\$29	\$86	\$87
Interest income	2	2	5	4
Income taxes	85	82	257	244
Depreciation	29	32	91	96
Amortization	3	3	12	12

39 |

---



Table of Contents

Adjusted net income, as shown above, excludes the following items:

(MILLIONS OF DOLLARS)	Three Months Ended		Nine Months Ended	
	September 27, 2015	September 28, 2014	September 27, 2015	September 28, 2014
Purchase accounting adjustments:				
Amortization and depreciation <sup>(a)</sup>	\$11	\$11	\$34	\$35
Cost of sales <sup>(b)</sup>	2	2	7	3
Total purchase accounting adjustments—pre-tax	13	13	41	38
Income taxes <sup>(c)</sup>	4	4	14	13
Total purchase accounting adjustments—net of tax	9	9	27	25
Acquisition-related costs:				
Integration costs <sup>(d)</sup>	5	1	9	5
Other <sup>(e)</sup>	1	—	2	—
Total acquisition-related costs—pre-tax	6	1	11	5
Income taxes <sup>(c)</sup>	—	1	(2	) 2
Total acquisition-related costs—net of tax	6	—	13	3
Certain significant items:				
Operational efficiency initiative <sup>(f)</sup>	21	—	294	—
Supply network strategy <sup>(g)</sup>	3	—	23	—
Other restructuring charges and cost-reduction/productivity initiatives <sup>(h)</sup>	—	1	—	5
Certain asset impairment charges <sup>(i)</sup>	—	6	2	6
Stand-up costs <sup>(i)</sup>	22	32	84	106
Net gains on sale of assets <sup>(k)</sup>	—	—	—	(3
Other <sup>(l)</sup>	—	(1	) 3	13
Total certain significant items—pre-tax	46	38	406	127
Income taxes <sup>(c)</sup>	(2	) 6	88	25
Total certain significant items—net of tax	48	32	318	102
Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax	\$63	\$41	\$358	\$130

Certain amounts may reflect rounding adjustments.

Amortization and depreciation expenses related to Purchase accounting adjustments with respect to identifiable intangible assets and property, plant and equipment were distributed as follows: \$1 million income included in Selling, general and administrative expenses in both the three and nine months ended September 28, 2014; \$1

<sup>(a)</sup> million included in Research and development expenses in both the nine months ended September 27, 2015, and the nine months ended September 28, 2014; \$11 million and \$33 million in the three and nine months ended September 27, 2015, respectively, and \$12 million and \$35 million in the three and nine months ended September 28, 2014, respectively, included in Amortization of intangible assets .

<sup>(b)</sup> Amortization and depreciation expense, as well as fair value adjustments to acquired inventory, included in Cost of sales.

<sup>(c)</sup> Included in Provision for taxes on income. Income taxes include the tax effect of the associated pre-tax amounts, calculated by determining the jurisdictional location of the pre-tax amounts and applying that jurisdiction's applicable tax rate. Income taxes in Purchase accounting adjustments for the nine months ended September 27, 2015, includes a tax benefit related to the revaluation of deferred taxes as a result of a change in tax rates. Income taxes in Acquisition-related costs for the nine months ended September 27, 2015, includes a tax charge related to the acquisition of certain assets of Abbott Animal Health. Income taxes in Certain significant items for the nine months ended September 27, 2015, includes a net tax benefit related to the revaluation of deferred taxes and other

deferred tax adjustments.

(d) Integration costs were included in Restructuring charges and certain acquisition-related costs.

(e) Included in Other (income)/deductions—net.

Includes restructuring charges of \$8 million related to asset impairments for the three months ended September 27, 2015, and restructuring charges of \$261 million related to employee termination costs (\$228 million) and asset impairments (\$33 million) for the nine months ended September 27, 2015,

(f) included in Restructuring charges and certain acquisition-related costs. Also includes inventory write-offs of \$5 million for the three and nine months ended September 27, 2015, included in Cost of sales, and \$8 million and \$28 million primarily related to consulting fees for the three and nine months ended September 27, 2015, respectively, included in Selling, general and administrative expenses.

(g) Includes restructuring charges of \$10 million related to employee termination costs (\$9 million) and asset impairments (\$1 million) for the nine months ended September 27, 2015, included in Restructuring charges and certain acquisition-related costs. Also includes charges of \$3 million and \$13 million primarily related to consulting fees for the three and nine months ended September 27, 2015, respectively, included in Cost of sales.

(h) Amounts relate to our cost-reduction/productivity initiatives and were included in Restructuring charges and certain acquisition-related costs. See Notes to Condensed Consolidated Financial Statements—Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

(i) Included in Other (income)/deductions—net. For the nine months ended September 27, 2015, represents an impairment of IPR&D assets related to the termination of a canine oncology project. For the three and nine months ended September 28, 2014, represents an impairment charge related to an IPR&D project acquired with the FDAH acquisition in 2009.

Table of Contents

Certain nonrecurring costs related to becoming an independent public company, such as new branding (including changes to the manufacturing process for required new packaging), the creation of standalone systems and infrastructure, site separation, and certain legal registration and patent assignment costs, which were distributed as follows: \$2 million and \$16 million in the three and nine months ended September 27, 2015, respectively, and \$3 million and \$14 million in the three and nine months ended September 28, 2014, respectively, included in Cost of sales; \$20 million and \$68 million in the three and nine months ended September 27, 2015, respectively, and \$29 million and \$90 million in the three and nine months ended September 28, 2014, respectively, included in Selling, general and administrative expenses; and \$2 million in the nine months ended September 28, 2014, included in Other (income)/deductions—net.

(i) For the nine months ended September 28, 2014, represents the Zoetis portion of a net gain on the sale of land by our Taiwan joint venture, included in Other (income)/deductions.

The nine months ended September 27, 2015, includes charges due to unusual investor-related activities of \$3 million, in Selling, general and administrative expenses. The nine months ended September 28, 2014, primarily includes a charge associated with a commercial settlement in Mexico of \$13 million, partially offset by the insurance recovery of \$1 million, both in Other (income)/deductions. The nine months ended September 28, 2014, also includes a pension plan settlement charge related to the divestiture of a manufacturing plant of \$4 million, partially offset by a \$2 million insurance recovery related to litigation-related charges, both in Other (income)/deductions.

Our financial guidance for 2015

Our 2015 financial guidance is summarized below:

## Selected Line Items

Revenue	\$4,700 to \$4,750 million
Operational growth <sup>(a)</sup>	6.5% to 7.5%
Adjusted cost of sales as a percentage of revenue <sup>(b)</sup>	Approximately 35%
Adjusted SG&A expenses <sup>(b)</sup>	\$1,375 to \$1,405 million
Adjusted R&D expenses <sup>(b)</sup>	\$350 to \$370 million
Adjusted interest expense and other (income)/deductions <sup>(b)</sup>	Approximately \$110 million
Adjusted EBIT <sup>(c)</sup> margin <sup>(b)</sup>	Approximately 28%
Effective tax rate on adjusted income <sup>(b)</sup>	Approximately 28%
Adjusted diluted EPS <sup>(b)</sup>	\$1.70 to \$1.74
Adjusted net income	\$855 to \$875 million
Operational growth <sup>(a)</sup>	16% to 19%
Certain significant items <sup>(d)</sup> and acquisition-related costs	\$470 to \$490 million
Reported diluted EPS	\$0.82 to \$0.89

(a) Growth excluding the impact of foreign exchange.

(b) For an understanding of adjusted net income and its components, see the “Adjusted net income” section of this MD&A.

(c) Earnings before interest and taxes.

(d) Includes certain nonrecurring costs related to restructuring and other charges for the operational efficiency initiative and supply network strategy, becoming an independent public company, such as new branding (including changes to the manufacturing process for required new packaging), the creation of standalone systems and infrastructure, site separation and certain legal registration and patent assignment costs.

In updating our guidance for full-year 2015, we have considered current exchange rates and other factors.

A reconciliation of 2015 adjusted net income and adjusted diluted EPS guidance to 2015 reported net income attributable to Zoetis and reported diluted EPS attributable to Zoetis common shareholders guidance follows:

(MILLION OF DOLLARS, EXCEPT PER SHARE AMOUNTS)	Full-Year 2015 Guidance	
	Net Income	Diluted EPS
Adjusted net income/diluted EPS <sup>(a)</sup> guidance	~\$855 - \$875	~\$1.70 - \$1.74

Edgar Filing: Zoetis Inc. - Form 10-Q

Purchase accounting adjustments	~(40)	~(0.08)
Certain significant items <sup>(b)</sup> and acquisition-related costs	~(385 - 400)	~(0.77 - 0.80)
Reported net income attributable to Zoetis Inc./diluted EPS guidance	~\$415 - \$450	~\$0.82 - \$0.89

(a) For an understanding of adjusted net income, see the “Adjusted net income” section of this MD&A.

Includes certain nonrecurring costs related to restructuring and other charges for the operational efficiency initiative and supply network strategy, becoming an independent public company, such as new branding (including changes to the manufacturing process for required new packaging), the creation of standalone systems and infrastructure, site separation and certain legal registration and patent assignment costs.

(b) Our 2015 financial guidance is subject to a number of factors and uncertainties—as described in the “Forward-looking information and factors that may affect future results,” “Our operating environment” and “Our strategy” and in Part I, Item 1A. “Risk Factors” of our 2014 Annual Report on Form 10-K.

Table of Contents

Analysis of the condensed consolidated statements of comprehensive income

Substantially all changes in other comprehensive income for the periods presented are related to foreign currency translation adjustments. These changes result from the strengthening or weakening of the U.S. dollar as compared to the currencies in the countries in which we do business. The gains and losses associated with these changes are deferred on the balance sheet in Accumulated other comprehensive loss until realized.

Analysis of the condensed consolidated balance sheets

September 27, 2015 vs. December 31, 2014

For a discussion about the changes in Cash and cash equivalents, Short-term borrowings, Current portion of long-term debt, and Long-term debt, see “Analysis of financial condition, liquidity and capital resources” below.

Accounts receivable, less allowance for doubtful accounts increased as a result of the timing of customer collections, due in part to temporary billing disruptions experienced during our U.S. enterprise resource planning (ERP) implementation in the second quarter of 2015, which impacted collections in the third quarter of 2015. The increase was partially offset by the impact of foreign exchange and an increase in the allowance for doubtful accounts.

Inventories increased primarily to support certain production transfers and production phasing, increased commercial demand of selected products, and purchases of inventory associated with the acquisition of certain assets from Abbott Animal Health. These increases were partially offset by the impact of foreign exchange and a reclassification of certain inventories to Assets held for sale. See Notes to Condensed Consolidated Financial Statements— Note 5.

Acquisitions and Divestitures and Note 10. Inventories for additional information.

The net changes in Current deferred tax assets, Noncurrent deferred tax assets, Noncurrent deferred tax liabilities, Income taxes payable and Other taxes payable primarily reflect adjustments to the accrual for the income tax provision for the third quarter of 2015, as well as the impact of a revaluation of deferred taxes as a result of a change in tax rates. See Notes to Condensed Consolidated Financial Statements— Note 8. Income Taxes.

Other current assets increased primarily as a result of higher prepaid expenses.

Assets held for sale reflects the reclassification of certain inventory, goodwill and property, plant and equipment, less accumulated depreciation associated with a pending divestiture. See Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures—Assets Held for Sale.

Property, plant and equipment, less accumulated depreciation decreased primarily as a result of depreciation expense, the impact of foreign exchange and fixed asset impairments. These decreases were partially offset by capital spending.

Goodwill increased primarily as a result of the acquisition of certain assets from Abbott Animal Health. See Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures and Note 11. Goodwill and Other Intangible Assets.

Identifiable intangible assets, less accumulated amortization decreased primarily as a result of amortization expense, as well as intangible asset impairments primarily associated with our operational efficiency initiatives, and the impact of foreign exchange. These decreases were partially offset by the acquisition of certain assets from Abbott Animal Health. See Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures—Acquisition of Abbott Animal Health and Note 11. Goodwill and Other Intangible Assets.

Accounts payable increased as a result of the timing of payments, partially offset by the impact of foreign exchange. Accrued compensation and related items decreased, primarily due to payment of 2014 annual bonuses to eligible employees and 2014 employee savings plan contributions, partially offset by the pro-rata accrual of similar items for 2015.

Dividends payable decreased, reflecting the payment of dividends declared on December 17, 2014, and paid on March 3, 2015.

Accrued expenses and Other current liabilities increased primarily as a result of the 2015 second quarter accrual of employee termination costs associated with our operational efficiency initiatives and the 2015 first quarter recognition of the contingent purchase price consideration to be paid to Abbott. See Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures—Acquisition of Abbott Animal Health and Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

Other non-current liabilities increased primarily as a result of the 2015 second quarter accrual of employee termination costs associated with our operational efficiency initiatives. See Notes to Condensed Consolidated Financial Statements— Note 6. Restructuring Charges and Other Costs Associated with Acquisitions and Cost-Reduction/Productivity Initiatives.

For an analysis of the changes in Total Equity, see the Condensed Consolidated Statements of Equity and Notes to Condensed Consolidated Financial Statements— Note 14. Stockholders' Equity.

## Analysis of the condensed consolidated statements of cash flows

(MILLIONS OF DOLLARS)	Nine Months Ended		
	September 27, 2015	September 28, 2014	% Change
Net cash provided by (used in):			
Operating activities	\$386	\$239	62
Investing activities	(378)	(137)	*
Financing activities	(271)	(112)	*
Effect of exchange-rate changes on cash and cash equivalents	(27)	(2)	*
Net decrease in cash and cash equivalents	\$(290)	\$(12)	*

\* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

#### Operating activities

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Net cash provided by operating activities was \$386 million for the nine months ended September 27, 2015, compared with net cash provided by operating activities of \$239 million for the nine months ended September 28, 2014. The increase in operating cash flows was primarily attributable to the timing of receipts and payments in the ordinary course of business, including the settlement of payables with Pfizer. This increase was partially offset by lower income before allocation to noncontrolling interests, as adjusted for depreciation and amortization, as well as higher inventory levels.

#### Investing activities

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Our net cash used in investing activities was \$378 million for the nine months ended September 27, 2015, compared with net cash used in investing activities of \$137 million for the nine months ended September 28, 2014. The increase in investing cash flows is primarily attributable to the acquisition of certain assets of Abbott Animal Health.

#### Financing activities

Nine months ended September 27, 2015 vs. nine months ended September 28, 2014

Our net cash used in financing activities was \$271 million for the nine months ended September 27, 2015, compared with cash used in financing activities of \$112 million for the nine months ended September 28, 2014. The net cash used in financing activities for 2015 was due primarily to the purchase of treasury shares and the payment of dividends. The net cash used in financing activities for 2014 was primarily attributable to the payment of dividends.

#### Analysis of financial condition, liquidity and capital resources

While we believe our cash and cash equivalents on hand, our operating cash flows and our existing financing arrangements will be sufficient to support our future cash needs, this may be subject to the environment in which we operate. Risks to our meeting future funding requirements include global economic conditions described in the following paragraph.

Global financial markets may be impacted by macroeconomic, business and financial volatility. As markets change, we will continue to monitor our liquidity position, but there can be no assurance that a challenging economic environment or an economic downturn will not impact our liquidity or our ability to obtain future financing.

Table of Contents

Selected measures of liquidity and capital resources

Certain relevant measures of our liquidity and capital resources follow:

	September 27, 2015	December 31, 2014
(MILLIONS OF DOLLARS)		
Cash and cash equivalents	\$592	\$882
Accounts receivable, net <sup>(a)</sup>	1,038	980
Short-term borrowings	8	7
Current portion of long-term debt	400	—
Long-term debt	3,226	3,624
Working capital	1,792	2,379
Ratio of current assets to current liabilities	2.08:1	3.19:1

Accounts receivable are usually collected over a period of 60 to 90 days. We regularly monitor our accounts receivable for collectability, particularly in markets where economic conditions remain uncertain. We believe that our allowance for doubtful accounts is appropriate. Our assessment is based on such factors as past due aging, <sup>(a)</sup> historical and expected collection patterns, the financial condition of our customers, the robust nature of our credit and collection practices and the economic environment. The increase in Accounts receivable, net as of September 27, 2015, is the result of the timing of customer collections, due in part to temporary billing disruptions experienced during our U.S. ERP implementation in the second quarter of 2015. These disruptions impacted collections in the third quarter of 2015.

For additional information about the sources and uses of our funds, see the "Analysis of the condensed consolidated balance sheets" and "Analysis of the condensed consolidated statements of cash flows" sections of this MD&A.

Credit facility and other lines of credit

In December 2012, we entered into a revolving credit agreement with a syndicate of banks providing for a five-year \$1.0 billion senior unsecured revolving credit facility, which became effective in February 2013 upon the completion of the IPO and which expires in December 2017. Subject to certain conditions, we have the right to increase the credit facility to up to \$1.5 billion. The credit facility contains a financial covenant requiring us to not exceed a maximum total leverage ratio (the ratio of consolidated net debt as of the end of the period to consolidated Earnings Before Interest, Income Taxes, Depreciation and Amortization (EBITDA) for such period) of 3.50:1 for fiscal year 2015 and 3.00:1 thereafter. The credit facility also contains a financial covenant requiring that we maintain a minimum interest coverage ratio (the ratio of EBITDA at the end of the period to interest expense for such period) of 3.50:1. In addition, the credit facility contains other customary covenants. We were in compliance with all financial covenants as of September 27, 2015. There were no borrowings outstanding as of September 27, 2015, or December 31, 2014. We have additional lines of credit and other credit arrangements with a group of banks and other financial intermediaries for general corporate purposes. We maintain cash and cash equivalent balances in excess of our outstanding short-term borrowings. As of September 27, 2015, we had access to \$79 million of lines of credit which expire at various times through 2017. Short-term borrowings outstanding related to these facilities were \$8 million and \$7 million as of September 27, 2015, and December 31, 2014, respectively. Long-term borrowings outstanding related to these facilities were \$2 million and \$3 million as of September 27, 2015, and December 31, 2014, respectively.

Domestic and international short-term funds

Many of our operations are conducted outside the United States. The amount of funds held in the United States will fluctuate due to the timing of receipts and payments in the ordinary course of business and due to other reasons, such as business development activities. As part of our ongoing liquidity assessments, we regularly monitor the mix of U.S. and international cash flows (both inflows and outflows). Repatriation of overseas funds can result in additional U.S. federal, state and local income tax payments. We record U.S. deferred tax liabilities for certain unremitted earnings, but when amounts earned overseas are expected to be indefinitely reinvested outside the United States, no accrual for U.S. taxes is provided.

Global economic conditions



The challenging economic environment has not had, nor do we anticipate that it will have, a significant impact on our liquidity. Due to our operating cash flows, financial assets, access to capital markets and available lines of credit and revolving credit agreements, we continue to believe that we have the ability to meet our liquidity needs for the foreseeable future. As markets change, we continue to monitor our liquidity position. There can be no assurance that a challenging economic environment or a further economic downturn would not impact our ability to obtain financing in the future.

#### Debt

On January 28, 2013, we issued \$3.65 billion aggregate principal amount of our senior notes (the senior notes offering) in a private placement, with an original issue discount of \$10 million. The senior notes are comprised of \$400 million aggregate principal amount of our 1.150% senior notes due 2016, \$750 million aggregate principal amount of our 1.875% senior notes due 2018, \$1.35 billion aggregate principal amount of our 3.250% senior notes due 2023 and \$1.15 billion aggregate principal amount of our 4.700% senior notes due 2043.

We sold \$2.65 billion aggregate principal amount of our senior notes through the initial purchasers in the senior notes offering and Pfizer transferred \$1.0 billion aggregate principal amount of our senior notes to certain of the initial purchasers, who sold such senior notes through the initial purchasers in the senior notes offering. We paid an amount of cash equal to substantially all of the net proceeds that we received in the senior notes offering to Pfizer prior to the completion of the IPO.

Table of Contents

The senior notes are governed by an indenture and supplemental indenture (collectively, the indenture) between us and Deutsche Bank Trust Company Americas, as trustee. The indenture contains certain covenants, including limitations on our and certain of our subsidiaries' ability to incur liens or engage in sale leaseback transactions. The indenture also contains restrictions on our ability to consolidate, merge or sell substantially all of our assets. In addition, the indenture contains other customary terms, including certain events of default, upon the occurrence of which the senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the senior notes of any series, in whole or in part, at any time by paying a "make whole" premium, plus accrued and unpaid interest to, but excluding, the date of redemption. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2023 notes pursuant to this optional redemption provision, except under limited circumstances. Upon the occurrence of a change of control of us and a downgrade of the senior notes below an investment grade rating by each of Moody's Investors Service, Inc. and Standard & Poor's Ratings Services, we are, in certain circumstances, required to make an offer to repurchase all of the outstanding senior notes at a price equal to 101% of the aggregate principal amount of the senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

The components of our long-term debt, including the current portion of long-term debt, follow:

Description	Principal Amount	Interest Rate	Terms
Lines of credit	\$2 million	6.400%	Due 2016-2018
2016 Senior Note	\$400 million	1.150%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2016
2018 Senior Note	\$750 million	1.875%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2018
2023 Senior Note	\$1,350 million	3.250%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2023
2043 Senior Note	\$1,150 million	4.700%	Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2043

**Interest Rate Swap Contracts**

The company may use interest rate swap contracts on certain investing and borrowing transactions to manage its net exposure to interest rates and to reduce its overall cost of borrowing. In anticipation of issuing fixed-rate debt, we may use forward starting interest rate swaps that are designated as cash flow hedges to hedge against changes in interest rates that could impact expected future issuances of debt. To the extent these hedges of cash flows related to anticipated debt are effective, any unrealized gains or losses on the forward starting interest rate swaps are reported in Accumulated other comprehensive loss and are recognized in income over the life of the future fixed-rate notes. When the company discontinues hedge accounting because it is no longer probable that an anticipated transaction will occur within the originally expected period of execution, or within an additional two-month period thereafter, changes to fair value accumulated in other comprehensive income are recognized immediately in earnings.

In the third quarter of 2015, we entered into four interest rate swaps with an aggregate notional value of \$300 million. We designated these swaps as cash flow hedges against interest rate exposure related principally to the anticipated future issuance of fixed-rate debt to be used primarily to refinance our 1.150% senior notes due in 2016. Contracts outstanding at September 27, 2015, have a mandatory termination within three months.

**Credit Ratings**

Two major corporate debt-rating organizations, Moody's and S&P, assign ratings to our short-term and long-term debt. A security rating is not a recommendation to buy, sell or hold securities and the rating is subject to revision or withdrawal at any time by the rating organization. Each rating should be evaluated independently of any other rating. The following table provides the current ratings assigned by these rating agencies to our commercial paper and senior unsecured non-credit-enhanced long-term debt:

Name of Rating Agency	Commercial			Date of Last Action
	Paper Rating	Long-term Debt Rating	Outlook	

Moody's	P-2	Baa2	Stable	November 2015
S&P	A-3	BBB-	Stable	November 2015

#### Contractual Obligations

On February 10, 2015, we completed the purchase of certain assets of Abbott Animal Health, a subsidiary of Abbott Laboratories (Abbott). The \$254 million purchase price included cash of \$229 million and an additional contingent payment of \$25 million which is due to Abbott within one year of the acquisition date, subject to certain deductions in the event of sales disruptions due to supply issues. The range of undiscounted amounts that Zoetis could pay pursuant to this contingent consideration arrangement is between zero and \$25 million, with an acquisition date fair value of \$22 million. The contingent liability was recorded at the acquisition date fair value of \$22 million and was included in Other current liabilities. At September 27, 2015, the fair value of the contingent liability was \$24 million.

For additional information, see Notes to Condensed Consolidated Financial Statements—Note 5. Acquisitions and Divestitures—Acquisition of Abbott Animal Health for further information.

Table of Contents

Share Repurchase Program

In November 2014, the company's Board of Directors authorized a \$500 million share repurchase program. Purchases of Zoetis shares may be made at the discretion of management, depending on market conditions and business needs. Share repurchases may be executed through various means, including open market or privately negotiated transactions. During the nine months ended September 27, 2015, approximately three million shares were repurchased. As of September 27, 2015, there was approximately \$352 million remaining under this authorization.

Off-balance sheet arrangements

In the ordinary course of business and in connection with the sale of assets and businesses, we may indemnify our counterparties against certain liabilities that may arise in connection with a transaction or that are related to activities prior to a transaction. These indemnifications typically pertain to environmental, tax, employee and/or product-related matters, and patent-infringement claims. If the indemnified party were to make a successful claim pursuant to the terms of the indemnification, we would be required to reimburse the loss. These indemnifications are generally subject to threshold amounts, specified claim periods and other restrictions and limitations. Historically, we have not paid significant amounts under these provisions and, as of September 27, 2015, or December 31, 2014, recorded amounts for the estimated fair value of these indemnifications are not significant.

New accounting standards

Recently Issued Accounting Standards Not Adopted as of September 27, 2015.

In September 2015, the Financial Accounting Standards Board (FASB) issued an accounting standards update to simplify the accounting for measurement period adjustments recorded during the one-year period following a business combination. The update removes the requirement for an acquirer in a business combination to account for measurement period adjustments retrospectively. Instead, an acquirer will recognize a measurement-period adjustment during the period in which the amount of the adjustment is determined. The provisions of the new standard are effective beginning January 1, 2016, for annual and interim periods. The guidance will be adopted prospectively and early adoption is permitted. We are currently assessing whether or not to early adopt this guidance.

In July 2015, the FASB issued an accounting standards update to simplify the measurement of inventory by requiring that inventory be measured at the lower of cost or net realizable value, rather than at the lower of cost or market with market being defined as either replacement cost, net realizable value or net realizable value less a normal profit margin. The provisions of the new standard are effective beginning January 1, 2017, for annual and interim reporting periods. The guidance will be adopted prospectively and early adoption is permitted. We are currently assessing the potential impact that the adoption of this guidance will have on our consolidated financial statements, as well as whether or not to early adopt this guidance.

In February 2015, the FASB issued an accounting standards update that provides revised guidance on whether to consolidate certain legal entities, such as limited partnerships, limited liability corporations and securitization structures. We plan to adopt this guidance as of January 1, 2016, the required effective date, and do not expect this guidance to have a significant impact on our consolidated financial statements.

In May 2014, the FASB issued an accounting standards update that outlines a new, single comprehensive model for companies to use in accounting for revenue arising from contracts with customers. This update supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance includes a five-step model for determining how, when and how much revenue should be recognized. This update also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB issued a one year deferral of the effective date. The provisions of the new standard are now effective for Zoetis beginning January 1, 2018, for annual and interim reporting periods. Early adoption is permitted beginning on January 1, 2017. The new standard allows for either full retrospective or modified retrospective transition upon adoption. We continue to assess the transition method we will elect for adoption as well as the potential impact that adopting this new guidance will have on our consolidated financial statements.

Forward-looking statements and factors that may affect future results

This report contains “forward-looking” statements. We generally identify forward-looking statements by using words such as “anticipate,” “estimate,” “could,” “expect,” “intend,” “project,” “plan,” “predict,” “believe,” “seek,” “continue,” “outlook,” “target,” “may,” “might,” “will,” “should,” “can have,” “likely” or the negative version of these words or comparable words or using future dates in connection with any discussion of future performance, actions or events.

In particular, forward-looking statements include statements relating to our indebtedness, our ability to make interest and principal payments on our indebtedness, our ability to satisfy the covenants contained in our indebtedness, the redemption of the notes, new systems infrastructure stand-up, our 2015 financial guidance, future actions, business plans or prospects, prospective products, product approvals or products under development, product supply disruptions, R&D costs, timing and likelihood of success, future operating or financial performance, future results of current and anticipated products and services, strategies, sales efforts, expenses, production efficiencies, production margins, interest rates, foreign exchange rates, growth in emerging markets, the outcome of contingencies, such as legal proceedings, plans related to share repurchases and dividends, our agreements with Pfizer, the expected timing and content of regulatory actions, government regulation and financial results. These statements are not guarantees of future performance, actions or events. Forward-looking statements are subject to risks and uncertainties, many of which are beyond our control, and are potentially inaccurate assumptions. Among the factors that could cause actual results to differ materially from past results and future plans and projected future results are the following:

46 |

---

Table of Contents

emerging restrictions and bans on the use of antibacterials in food-producing animals;  
perceived adverse effects on human health linked to the consumption of food derived from animals that utilize our products;  
increased regulation or decreased governmental support relating to the raising, processing or consumption of food-producing animals;  
fluctuations in foreign exchange rates and potential currency controls;  
changes in tax laws, regulations, and challenges brought against our incentive tax rulings;  
legal factors, including product liability claims, antitrust litigation and governmental investigations, including tax disputes, environmental concerns, commercial disputes and patent disputes with branded and generic competitors, any of which could preclude commercialization of products or negatively affect the profitability of existing products;  
failure to protect our intellectual property rights or to operate our business without infringing the intellectual property rights of others;  
an outbreak of infectious disease carried by animals;  
adverse weather conditions and the availability of natural resources;  
adverse global economic conditions;  
failure of our R&D, acquisition and licensing efforts to generate new products;  
the possible impact of competing products, including generic alternatives, on our products and our ability to compete against such products;  
quarterly fluctuations in demand and costs;  
governmental laws and regulations affecting domestic and foreign operations, including without limitation, tax obligations and changes affecting the tax treatment by the United States of income earned outside the United States that may result from pending and possible future proposals; and  
governmental laws and regulations affecting our interactions with veterinary healthcare providers.  
However, there may also be other risks that we are unable to predict at this time. These risks or uncertainties may cause actual results to differ materially from those contemplated by a forward-looking statement. You should not put undue reliance on forward-looking statements. Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law or by the rules and regulations of the SEC. You are advised, however, to consult any further disclosures we make on related subjects in our Form 10-Q and 8-K reports and our other filings with the SEC. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider the above to be a complete discussion of all potential risks or uncertainties.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

A significant portion of our revenue and costs are exposed to changes in foreign exchange rates. In addition, our outstanding borrowings may be subject to risk from changes in interest rates and foreign exchange rates. The overall objective of our financial risk management program is to seek to minimize the impact of foreign exchange rate movements and interest rate movements on our earnings. We manage these financial exposures through operational means and by using certain financial instruments. These practices may change as economic conditions change.

#### Foreign exchange risk

Our primary net foreign currency translation exposures are the euro, Brazilian real, Canadian dollar and Australian dollar. We seek to manage our foreign exchange risk, in part, through operational means, including managing same-currency revenue in relation to same-currency costs and same-currency assets in relation to same-currency liabilities.

Foreign exchange risk is also managed through the use of foreign currency forward-exchange contracts. These contracts are used to offset the potential earnings effects from mostly intercompany short-term foreign currency assets and liabilities that arise from operations.

Our financial instrument holdings at September 27, 2015, were analyzed to determine their sensitivity to foreign exchange rate changes. The fair values of these instruments were determined using Level 2 inputs. The sensitivity analysis of changes in the fair value of all foreign currency forward-exchange contracts at September 27, 2015, indicates that if the U.S. dollar were to appreciate against all other currencies by 10%, the fair value of these contracts would increase by \$29 million, and if the U.S. dollar were to weaken against all other currencies by 10%, the fair value of these contracts would decrease by \$16 million. For additional details, see Notes to Condensed Consolidated Financial Statements—Note 9B. Financial Instruments: Derivative Financial Instruments.

#### Interest rate risk

Our outstanding debt balances are fixed rate debt. While changes in interest rates will have no impact on the interest we pay on our fixed rate debt, interest on our revolving credit facility will be exposed to interest rate fluctuations. At September 27, 2015, we had no outstanding principal balance under our revolving credit facility. See Notes to Condensed Consolidated Financial Statements—Note 9. Financial Instruments.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of the company's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation as of September 27, 2015, the company's Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures are effective at a reasonable level of assurance in alerting them in a timely manner to material information required to be disclosed in our periodic reports filed with the SEC.

#### Changes in Internal Control over Financial Reporting

During our most recent fiscal quarter, there has not been any change in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We are currently migrating many of our financial reporting and processing systems to an enterprise-wide solution. These system implementations are part of our ongoing stand-up efforts, and we plan to continue to implement such systems throughout the business. We expect to complete the implementations in the next year. In connection with these implementations and resulting business process changes, we will enhance the design and documentation of our internal control over financial reporting process to maintain effective controls over our financial reporting.

Table of Contents

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

The information required by this Item is incorporated herein by reference to Notes to Condensed Consolidated Financial Statements—Note 16. Commitments and Contingencies in Part I, Item 1, of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed in the "Our Operating Environment" and "Forward-Looking Information and Factors That May Affect Future Results" sections of the MD&A and in Part I, Item 1A. "Risk Factors," of our 2014 Annual Report on Form 10-K, which could materially affect our business, financial condition, or future results and which are incorporated by reference herein. Set forth below are updates to certain of the risk factors disclosed in our 2014 Annual Report on Form 10-K.

Risks related to our business and industry

Restrictions and bans on the use of antibacterials in food-producing animals may become more prevalent.

The issue of the potential transfer of increased antibacterials resistance in bacteria from food-producing animals to human pathogens, and the causality of that transfer, continue to be the subject of global scientific and regulatory discussion. Antibacterials refer to small molecules that can be used to treat or prevent bacterial infections and are a sub-categorization of the products that make up our anti-infectives and medicated feed additives portfolios. In some countries, this issue has led to government restrictions and bans on the use of specific antibacterials in some food-producing animals, regardless of the route of administration (in feed or injectable). These restrictions are more prevalent in countries where animal protein is plentiful and governments are willing to take action even when there is scientific uncertainty. Our total revenue attributable to antibacterials for livestock was approximately \$1.3 billion for the year ended December 31, 2014.

For example, in December 2013, the FDA announced final guidance establishing procedures for the voluntary phase out in the United States over a three-year period of the use of medically important antibacterials in animal feed for growth promotion in food production animals (medically important antibacterials include classes that are prescribed in animal and human health). The guidance provides for continued use of antibacterials in food producing animals for treatment, control and under certain circumstances for prevention of disease, all under the supervision of a veterinarian. Our total revenue attributable to medicated feed additives was approximately \$479 million for the year ended December 31, 2014. The FDA indicated that they took this action to help preserve the efficacy of medically important antibacterials to treat infections in humans. Zoetis supports the FDA's efforts to voluntarily phase-out growth promotion indications for medically important antibiotics in food producing animals and will comply with procedures outlined in the December 2013 FDA guidance.

In addition, in October 2014, the French Parliament passed a law that, inter-alia, prohibits rebates and discounts on antibiotics and requires the reporting of antibiotics sold to and agreements entered into with certain animal healthcare providers (including veterinarians, veterinary schools, pharmacists and students). The Parliament indicated that the law is in response to a government initiative aimed at fighting antimicrobial resistance in animals and reducing the use of certain categories of antibiotics by 25% (compared to 2013) by December 31, 2016.

We cannot predict whether antibacterials resistance concerns will result in additional restrictions or bans, expanded regulations or public pressure to discontinue or reduce use of antibacterials in food-producing animals, which could materially adversely affect our operating results and financial condition.

We may experience difficulties, delays or unexpected costs and not achieve anticipated benefits and savings from our recently announced comprehensive operational efficiency initiative.

On May 5, 2015, we announced an initiative to simplify our operations, improve our efficiency and cost structure, and better allocate our resources to key growth opportunities in animal health. As part of the initiative, we have reduced staff and plan to close or divest certain facilities. We may not realize, in full or in part, the anticipated benefits and savings from our efforts due to unforeseen difficulties, the complexity inherent in unwinding our current structure, and delays or unexpected costs, which may adversely affect our business and results of operations.

Following the completion of our program, we will execute our business initiatives with fewer staff and, in some instances, existing employees will be transitioning to new key roles. We must also attract, retain and motivate key



employees who are critical to our business. If we are unable to effectively execute with fewer staff members, transition key roles and/or attract, retain and motivate key employees, it may adversely impact our business.

49 |

---

#### Risks related to manufacturing

Manufacturing problems and capacity imbalances may cause product launch delays, inventory shortages, recalls or unanticipated costs.

In order to sell our products, we must be able to produce and ship our products in sufficient quantities. We have a global manufacturing network consisting of 27 manufacturing sites located in 10 countries. In addition, 11 Pfizer sites located in 11 countries manufacture certain of our products for us. Included in these Pfizer sites is our facility in Guarulhos, Brazil, where Pfizer will continue its manufacturing operations for a period of time. These Pfizer sites consist of sites operated by Pfizer that, immediately prior to the Separation, predominantly manufactured human health products. We also employ a network of approximately 200 CMOs. Many of our products involve complex manufacturing processes and are sole-sourced from certain manufacturing sites.

Minor deviations in our manufacturing or logistical processes, such as temperature excursions or improper package sealing, could result in delays, inventory shortages, unanticipated costs, product recalls, product liability and/or regulatory action. In addition, a number of factors could cause production interruptions, including:

• the failure of us or any of our vendors or suppliers, including logistical service providers, to comply with applicable regulations and quality assurance guidelines;

• construction delays;

• equipment malfunctions;

• shortages of materials;

• labor problems;

• natural disasters;

• power outages;

• criminal and terrorist activities;

• changes in manufacturing production sites and limits to manufacturing capacity due to regulatory requirements,

changes in types of products produced, shipping distributions or physical limitations; and

• the outbreak of any highly contagious diseases near our production sites.

These interruptions could result in launch delays, inventory shortages, recalls, unanticipated costs or issues with our agreements under which we supply third parties, which may adversely affect our operating results. For example, our manufacturing site in Medolla, Italy was damaged in an earthquake in May 2012, which resulted in production interruptions at that site. In addition, we have experienced challenges in manufacturing Apoquel that have impacted our ability to meet customer demand. As a result, we have had to place limits on the amounts of this product veterinarians can purchase and have delayed the launch of the product in certain markets.

Our manufacturing network may be unable to meet the demand for our products or we may have excess capacity if demand for our products changes. The unpredictability of a product's regulatory or commercial success or failure, the lead time necessary to construct highly technical and complex manufacturing sites, and shifting customer demand (including as a result of market conditions or entry of branded or generic competition) increase the potential for capacity imbalances. In addition, construction of sites is expensive, and our ability to recover costs will depend on the market acceptance and success of the products produced at the new sites, which is uncertain.

#### Risks related to our international operations

A significant portion of our operations are conducted in foreign jurisdictions and are subject to the economic, political, legal and business environments of the countries in which we do business.

Our international operations could be limited or disrupted by any of the following:

• volatility in the international financial markets;

• compliance with governmental controls;

• difficulties enforcing contractual and intellectual property rights;

• parallel trade in our products (importation of our products from European Union countries where our products are sold at lower prices into European Union countries where the products are sold at higher prices);

• compliance with a wide variety of laws and regulations, such as the FCPA and similar non-U.S. laws and regulations;

• compliance with foreign labor laws;

•

burdens to comply with multiple and potentially conflicting foreign laws and regulations, including those relating to environmental, health and safety requirements;  
changes in laws, regulations, government controls or enforcement practices with respect to our business and the businesses of our customers, including the imposition of limits on our profitability (e.g., the Venezuelan Law on Fair Pricing);  
political and social instability, including crime, civil disturbance, terrorist activities and armed conflicts;

50 |

---

trade restrictions and restrictions on direct investments by foreign entities, including restrictions administered by the OFAC and the European Union, in relation to our products or the products of farmers and other customers (e.g., restrictions on the importation of agricultural products from the European Union to Russia);

- changes in tax laws, challenges brought against our incentive tax rulings, and tariffs;
- imposition of antidumping and countervailing duties or other trade-related sanctions;
- costs and difficulties in staffing, managing and monitoring international operations;
- longer payment cycles and increased exposure to counterparty risk; and
- additional limitations on transferring personal information between countries.

In addition, international transactions may involve increased financial and legal risks due to differing legal systems and customs. Compliance with these requirements may prohibit the import or export of certain products and technologies or may require us to obtain a license before importing or exporting certain products or technology. A failure to comply with any of these laws, regulations or requirements could result in civil or criminal legal proceedings, monetary or non-monetary penalties, or both, disruptions to our business, limitations on our ability to import and export products and services, and damage to our reputation. In addition, variations in the pricing of our products between jurisdictions may result in the unauthorized importation or unauthorized re-importation of our products between jurisdictions and may also result in the imposition of antidumping and countervailing duties or other trade-related sanctions. While the impact of these factors is difficult to predict, any of them could materially adversely affect our operating results and financial condition. Changes in any of these laws, regulations or requirements, or the political environment in a particular country, may affect our ability to engage in business transactions in certain markets, including investment, procurement and repatriation of earnings.

Foreign exchange rate fluctuations and potential currency controls affect our results of operations, as reported in our financial statements.

We conduct operations in many areas of the world, involving transactions denominated in a variety of currencies. For the nine months ended September 27, 2015, we generated approximately 48% of our revenue in currencies other than the U.S. dollar, principally the euro and Brazilian real. We are subject to currency exchange rate risk to the extent that our costs are denominated in currencies other than those in which we earn revenue. In addition, because our financial statements are reported in U.S. dollars, changes in currency exchange rates between the U.S. dollar and other currencies have had, and will continue to have, an impact on our results of operations.

For example, on February 13, 2013, the Venezuelan government devalued its currency from a rate of 4.3 to 6.3 Venezuelan bolivars per U.S. dollar. We immediately incurred a foreign currency loss of \$9 million on the devaluation as a result of remeasuring the local assets and liabilities.

Our Venezuelan subsidiary's functional currency is the U.S. dollar because of the hyperinflationary status of the Venezuelan economy. In the first quarter of 2014, the Venezuelan government expanded its exchange mechanisms, resulting in three official rates of exchange for the Venezuelan bolivar.

On February 10, 2015, the Venezuelan government announced that they would continue to operate with a three-tier exchange rate system. In addition, they announced that the primary rate of 6.3 bolivars to the dollar would remain in place for imports that are deemed essential, and that a new free-floating rate (SIMADI) would replace the then-existing third-tier rate (SICAD II). As of September 27, 2015, the Venezuelan bolivar to U.S. dollar exchange rates were the CENCOEX rate of 6.3; the SICAD I rate of 13.5; and the SIMADI rate of 198.7. We continue to use the CENCOEX rate of 6.3 to report our Venezuela financial position, results of operations and cash flows.

We may experience adverse impacts to earnings as our revenue, costs and expenses may be translated into U.S. dollars at lower rates. As of February 22, 2015, we had net monetary assets denominated in local currency of \$82 million (\$86 million of which was in cash) in Venezuela and other consolidated entities had receivables from our Venezuela business of \$51 million. At August 23, 2015, we had \$41 million of Venezuelan bolivar that is awaiting government approval for settlement. For the nine months ended August 23, 2015, our revenue from the Venezuelan market was approximately \$57 million.

We cannot predict whether there will be further devaluation of the Venezuelan bolivar or whether our use of the 6.3 rate will continue to be supported by evolving facts and circumstances. Further, other potential actions by the Venezuelan government in response to economic uncertainties could impact the recoverability of our investment in Venezuela, which could result in a charge and, under extreme circumstances, could impact our ability to continue to

operate in the country in the same manner as we have historically.

We also face risks arising from currency devaluations and the imposition of cash repatriation restrictions and exchange controls. Currency devaluations result in a diminished value of funds denominated in the currency of the country instituting the devaluation. Cash repatriation restrictions and exchange controls may limit our ability to convert foreign currencies into U.S. dollars or to remit dividends and other payments by our foreign subsidiaries or businesses located in or conducted within a country imposing restrictions or controls. While we currently have no need, and do not intend, to repatriate or convert cash held in countries that have significant restrictions or controls in place, should we need to do so to fund our operations, we may be unable to repatriate or convert such cash, or be unable to do so without incurring substantial costs. We currently have substantial operations in countries that have cash repatriation restrictions or exchange controls in place, including China and Venezuela, and, if we were to need to repatriate or convert such cash, these controls and restrictions may have a material adverse effect on our operating results and financial condition.

51 |

---

## Risks related to information technology

We may experience difficulties with the implementation of our enterprise resource planning system, which could disrupt our business and adversely affect our results of operations and financial condition.

We are engaged in a multi-year implementation of an enterprise resource planning system (ERP). The ERP is designed to accurately maintain our books and records and provide information important to the operation of our business to our management team. The implementation of the ERP will require significant investment of human and financial resources. In implementing the ERP, we may experience significant delays, increased costs and other difficulties. While we have invested significant resources in planning, project management and training, additional and significant implementation issues may arise. For example, although the U.S. implementation of our ERP system has been successful from a systems and controls point of view, due to the large number of customers directly impacted by our change of systems, we have experienced challenges with certain of our customers experiencing a disruption in their service. Any significant disruption or deficiency in the design and implementation of the ERP could adversely affect our ability to process orders, ship product, send invoices and track payments, fulfill contractual obligations or otherwise operate our business. Any of these consequences could have an adverse effect on our results of operations and financial condition.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information with respect to the shares of the company's common stock repurchased during the quarter ended September 27, 2015:

	Issuer Purchases of Equity Securities			Approximate Dollar Value of Shares that May Yet Be Purchased Under Plans or Programs
	Total Number of Shares Purchased <sup>(a)</sup>	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs <sup>(b)</sup>	
June 29 - July 26, 2015	306,503	\$48.00	304,179	\$387,290,079
July 27 - August 23, 2015	336,854	\$48.59	333,327	371,091,436
August 24 - September 27, 2015	434,945	\$44.86	427,510	351,918,203
	1,078,302	\$46.91	1,065,016	\$351,918,203

<sup>(a)</sup> The company repurchased 13,286 shares during the three-month period ended September 27, 2015, that were not part of the publicly announced share repurchase authorization. These shares were reacquired from employees to satisfy tax withholding requirements on the vesting of restricted shares from equity-based awards.

<sup>(b)</sup> On November 18, 2014, the company announced that its Board of Directors had authorized the repurchase of up to \$500 million of our outstanding common stock.

## Item 3. Defaults Upon Senior Securities

None

## Item 4. Mine Safety Disclosures

None

## Item 5. Other Information

None.

Item 6. Exhibits

- Exhibit 3.1 Restated Certificate of Incorporation of the Registrant, effective as of May 13, 2014 (incorporated by reference to Exhibit 3.1 to Zoetis Inc.'s Quarterly Report on Form 10-Q filed on November 10, 2014)
- Exhibit 3.2 Amended and Restated By-laws of the Registrant (incorporated by reference to Exhibit 3.2 to Zoetis Inc.'s 2012 Annual Report on Form 10-K filed on March 28, 2013)
- Exhibit 10.1 Form of Indemnification Agreement for directors and officers (incorporated by reference to Exhibit 10.19 of Zoetis Inc.'s registration statement on Form S-1 (File No. 333-183254))
- Exhibit 10.2 Form of Performance Restricted Stock Unit Award Agreement, effective as of February 27, 2015 (incorporated by reference to Exhibit 99.1 to Zoetis Inc.'s Current Report on Form 8-K filed on March 4, 2015)
- Exhibit 10.3 Form of Restricted Stock Unit Award Agreement, effective as of February 27, 2015 (incorporated by reference to Exhibit 99.2 to Zoetis Inc.'s Current Report on Form 8-K filed on March 4, 2015)
- Exhibit 10.4 Form of Stock Option Award Agreement, effective as of February 27, 2015 (incorporated by reference to Exhibit 99.3 to Zoetis Inc.'s Current Report on Form 8-K filed on March 4, 2015)
- Exhibit 10.5 Form of Cash Award Agreement, effective as of February 27, 2015 (incorporated by reference to Exhibit 99.4 to Zoetis Inc.'s Current Report on Form 8-K filed on March 4, 2015)
- Exhibit 12 Computation of Ratio of Earnings to Fixed Charges
- Exhibit 15 Accountants' Acknowledgment
- Exhibit 31.1 Chief Executive Officer—Certification pursuant to Sarbanes-Oxley Act of 2002 Section 302
- Exhibit 31.2 Chief Financial Officer—Certification pursuant to Sarbanes-Oxley Act of 2002 Section 302
- Exhibit 32.1 Chief Executive Officer—Certification pursuant to Sarbanes-Oxley Act of 2002 Section 906
- Exhibit 32.2 Chief Financial Officer—Certification pursuant to Sarbanes-Oxley Act of 2002 Section 906
- EX-101.INS INSTANCE DOCUMENT
- EX-101.SCH SCHEMA DOCUMENT
- EX-101.CAL CALCULATION LINKBASE DOCUMENT
- EX-101.LAB LABELS LINKBASE DOCUMENT
- EX-101.PRE PRESENTATION LINKBASE DOCUMENT
- EX-101.DEF DEFINITION LINKBASE DOCUMENT

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Zoetis Inc.

November 5, 2015

By: /S/ JUAN RAMÓN ALAIX  
Juan Ramón Alaix  
Chief Executive Officer and Director

November 5, 2015

By: /S/ PAUL S. HERENDEEN  
Paul S. Herendeen  
Executive Vice President and  
Chief Financial Officer