

Beef 101 Day Increases Our Confidence in the Market Opportunity for Cattle; Buy ZTS, PAHC

SECTOR: Specialty Pharmaceuticals

June 23, 2014

On 6/19/14, we attended a **Beef 101 Day** hosted by SmartVet (Private), which underscored our investment thesis that an increasing need for Animal Health drugs that support healthier and more productive livestock will drive earnings upside for companies such as ZTS and PAHC. Please see our note [Deep Dive into Cattle Opportunity Suggests Growing Need for Drugs to Increase Productivity and Profitability](#). We spent an informative day in the heart of U.S. cattle country to get an overview of the **Beef Cattle Production Industry**, how it operates, animal health-care, parasite management and economic sustainability. We heard from leading industry experts, toured Kansas Cattle Ranch, and experienced live cattle parasite treatments (more details in body of the note). **Key takeaways from our meeting which support our investment thesis are as follows:**

- Cattle inventory is expected to grow through 2020. The drought caused 1.8MM cattle to be slaughtered. Producers are currently rebuilding their herd sizes, however breeding decisions taken today may take as long as 25 months to be seen in the cattle inventory.
- China could play a major role in driving demand for U.S. beef. If China lifts a ban on U.S. beef (from the 2003 BSE outbreak) this could significantly drive further demand and price increases for the U.S. cattle industry. Although no time-frame is currently in place for the lifting of the ban, last week Hong Kong lifted restrictions on U.S. beef imports. Japan is currently the U.S.'s largest export market with ~\$1.4B annually.
- Growing demand for beef will be driven by the East. The role of China will be very important going forward. The demand for beef products in China is expected to increase by 15% to 20% a year, for the next five years. U.S. beef is seen as premium beef in the Chinese market and as such is able to sustain higher prices than beef imported from other nations.
- One large, unmet need that Animal Health companies can help address are parasite resistance to existing drugs. Horn flies in particular have developed resistance. Many cattle are dosed at times which is not the most effective in managing parasites. However due to limitations, such as labor and weather, cattle are often dosed at times which are suitable for the producer, rather than optimal for pest management. Key opinion leaders estimate correct timing of dosing could lead to gains of one tenth to two tenths of a pound per day.

Potential Catalysts for Zoetis (ZTS, BUY, \$32.46): 1) Operating margin expansion; 2) new product launches; 3) business development; 4) expansion into adjacent categories; 5) new CFO.

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Potential Catalysts for Phibro (PAHC, BUY, \$20.49): 1) F'15 guidance mid-September; 2) Increasing market share and geographic expansion of existing products, '14+; 3) New product approvals and launches, '14+; 4) Gross margin and operating margin expansion, 14+; 5) Debt paydown reduces interest expense, 14+; 6) Tuck-in acquisitions, '14+.

BEEF CATTLE PRODUCTION INDUSTRY

How Does it Operate

- The cattle industry is more segmented than the other livestock industries, such as pork or poultry, which are more integrated.
- The life cycle of beef cattle is normally 14 to 16 months, however this may vary depending on a variety of economic factors, such as feed prices, beef prices and demand.

Animal Healthcare

- When cattle consume food they can either use this food to grow mass or build up their immune system to fight parasites. The more effective the treatments given to cattle to fight parasites are, the more productive cattle are as they are able to build mass faster.
- Appetite suppression is one of the biggest side effects of internal parasites in cattle. Cattle which have appetite suppression from internal parasites will not produce mass as quickly.

Parasite Management and Live Cattle Experience

- Current treatments on the market are effective, however it is the timing, dosage and proper rotation between classes of pesticides, which is not performed correctly. Experts believe correct timing of dosing could add between one tenth and two tenths of a pound to cattle per day.
- The best times to treat cattle depend on the life stage the cattle are in. Calves are best treated in the middle of summer, however most producers do not do this due to the heat, availability of labor, as well as this often being the time when farmers are harvesting wheat.

Economic Sustainability

- The cattle industry is a cyclical industry and as such beef prices are cyclical too. The liquidation in herd sizes seen in the past few years has been driven by external forces. However, the cattle industry has shifted to more effective production methods, which has decreased the need for as many heads of cattle.

What We Learned on Our Tour of Kansas Cattle Ranch

- Cattle farming is a very intensive process and as such producers place a high value on technology which reduces the demand for time and labor.
- We witnessed a demonstration of SmartVet's Vetgun (for parasite management). Cattle were dosed in the field while grazing. Producers we spoke with were very positive and excited about the Vetgun and Vetcaps as the dosing took significantly less time, and cattle were able to continue grazing shortly after being dosed. The producer was also able to dose the cattle alone, without the need for additional labor. We were impressed with the effectiveness of the dosing as many of the horn flies seen on the cattle no longer existed shortly after dosing.

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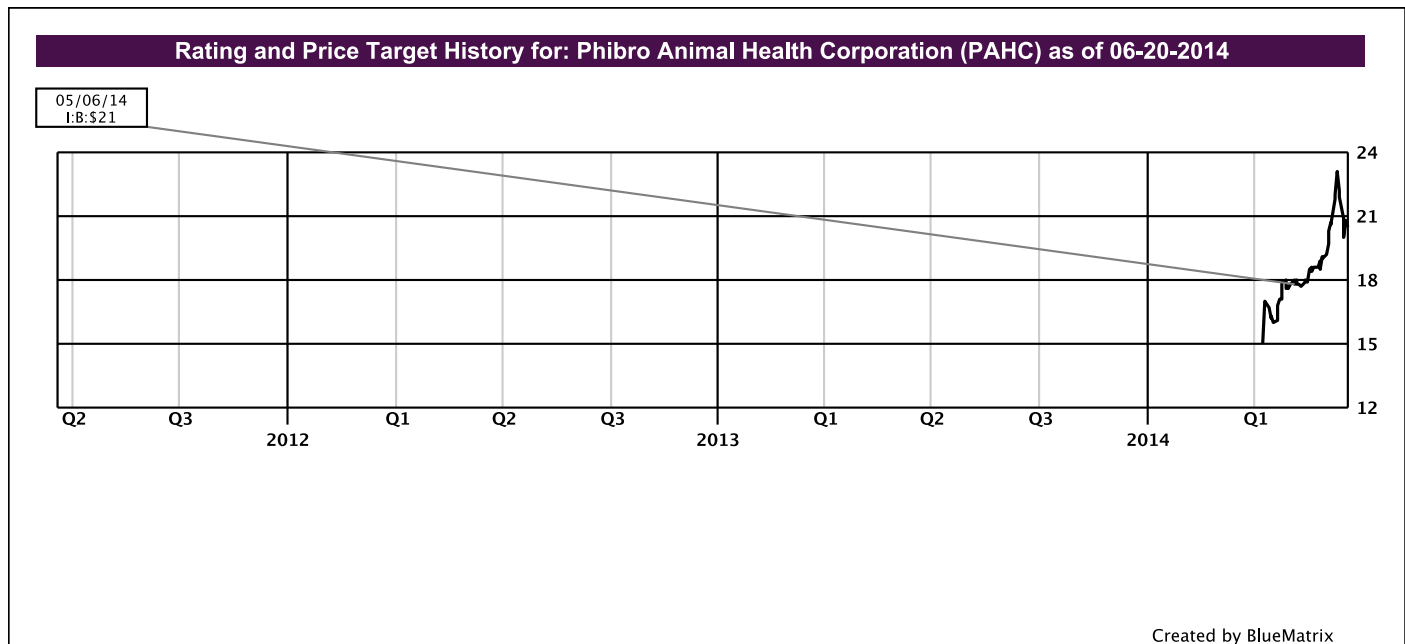
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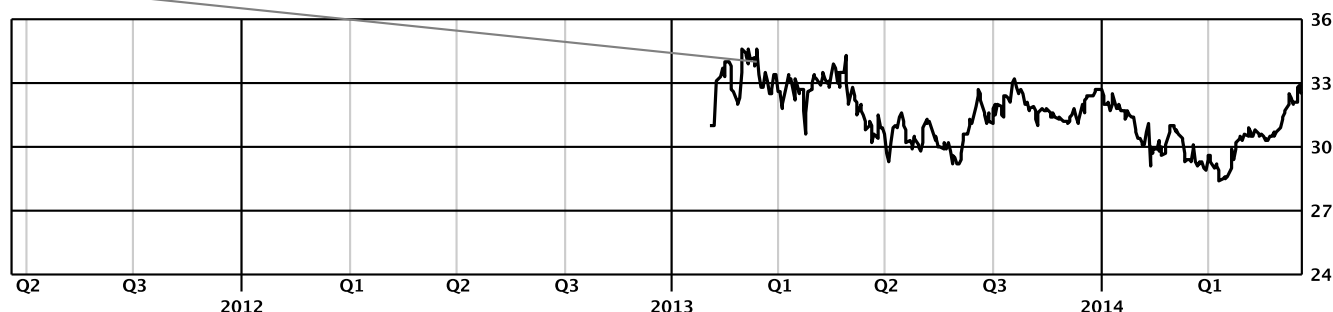
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Rating and Price Target History for: Zoetis Inc. (ZTS) as of 06-20-2014

03/13/13
I:B:\$40

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