

Zoetis Inc.
Form 10-Q
November 01, 2018
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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 30, 2018

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 (I.R.S. Employer Identification No.)
incorporation or organization)

10 Sylvan Way, Parsippany, New Jersey 07054
(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, smaller reporting company or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

At October 26, 2018, there were 480,450,882 shares of common stock outstanding.



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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 30, | October 1, | September 30, | October 1, |
| (MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA) | 2018 | 2017 | 2018 | 2017 |
| Revenue | \$1,480 | \$1,347 | \$4,261 | \$3,847 |
| Costs and expenses: | | | | |
| Cost of sales | 473 | 435 | 1,367 | 1,318 |
| Selling, general and administrative expenses | 367 | 328 | 1,064 | 973 |
| Research and development expenses | 108 | 96 | 307 | 272 |
| Amortization of intangible assets | 32 | 23 | 78 | 68 |
| Restructuring charges/(reversals) and certain acquisition-related costs | 47 | 8 | 54 | 7 |
| Interest expense, net of capitalized interest | 54 | 43 | 147 | 125 |
| Other (income)/deductions—net | (19) | 1 | (28) | (11) |
| Income before provision for taxes on income | 418 | 413 | 1,272 | 1,095 |
| Provision for taxes on income | 71 | 117 | 193 | 313 |
| Net income before allocation to noncontrolling interests | 347 | 296 | 1,079 | 782 |
| Less: Net loss attributable to noncontrolling interests | — | (2) | (4) | (1) |
| Net income attributable to Zoetis Inc. | \$347 | \$298 | \$1,083 | \$783 |
| Earnings per share attributable to Zoetis Inc. stockholders: | | | | |
| Basic | \$0.72 | \$0.61 | \$2.24 | \$1.60 |
| Diluted | \$0.71 | \$0.61 | \$2.22 | \$1.59 |
| Weighted-average common shares outstanding: | | | | |
| Basic | 482.0 | 489.1 | 483.9 | 490.8 |
| Diluted | 485.8 | 492.4 | 487.7 | 493.9 |
| Dividends declared per common share | \$— | \$— | \$0.252 | \$0.210 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Net income before allocation to noncontrolling interests | \$347 | \$296 | \$1,079 | \$782 |
| Other comprehensive (loss)/income, net of taxes and reclassification adjustments: | | | | |
| Unrealized losses on derivatives, net ^(a) | (1) | (10) | (1) | (11) |
| Foreign currency translation adjustments, net | (75) | 98 | (113) | 154 |
| Benefit plans: Actuarial gains, net ^(a) | — | — | — | 1 |
| Total other comprehensive (loss)/income, net of tax | (76) | 88 | (114) | 144 |
| Comprehensive income before allocation to noncontrolling interests | 271 | 384 | 965 | 926 |
| Less: Comprehensive (loss)/income attributable to noncontrolling interests | — | (1) | (4) | — |
| Comprehensive income attributable to Zoetis Inc. | \$271 | \$385 | \$969 | \$926 |

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

Reclassification adjustments related to benefit plans are generally reclassified, as part of net periodic pension cost,

^(a) into Other (income)/deductions, beginning in the first quarter of 2018, and into Cost of sales, Selling, general and administrative expenses, and/or Research and development expenses, as appropriate, for periods prior to 2018, in the condensed consolidated statements of income.

See notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2018 | December 31, 2017 |
|--|--------------------------|-------------------------|
| | (Unaudited) | |
| (MILLIONS OF DOLLARS, EXCEPT SHARE AND PER SHARE DATA) | | |
| Assets | | |
| Cash and cash equivalents ^(a) | \$ 1,286 | \$ 1,564 |
| Short term investments | 105 | — |
| Accounts receivable, less allowance for doubtful accounts of \$24 in 2018 and \$25 in 2017 | 929 | 998 |
| Inventories | 1,441 | 1,427 |
| Other current assets | 315 | 228 |
| Total current assets | 4,076 | 4,217 |
| Property, plant and equipment, less accumulated depreciation of \$1,559 in 2018 and \$1,471 in 2017 | 1,556 | 1,435 |
| Goodwill | 2,537 | 1,510 |
| Identifiable intangible assets, less accumulated amortization | 2,120 | 1,269 |
| Noncurrent deferred tax assets | 73 | 80 |
| Other noncurrent assets | 97 | 75 |
| Total assets | \$ 10,459 | \$ 8,586 |
| Liabilities and Equity | | |
| Accounts payable | \$ 238 | \$ 261 |
| Dividends payable | — | 61 |
| Accrued expenses | 425 | 432 |
| Accrued compensation and related items | 226 | 236 |
| Income taxes payable | 75 | 60 |
| Other current liabilities | 39 | 44 |
| Total current liabilities | 1,003 | 1,094 |
| Long-term debt, net of discount and issuance costs | 6,441 | 4,953 |
| Noncurrent deferred tax liabilities | 446 | 380 |
| Other taxes payable | 250 | 172 |
| Other noncurrent liabilities | 201 | 201 |
| Total liabilities | 8,341 | 6,800 |
| Commitments and contingencies (Note 16) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value: 1,000,000,000 authorized, none issued | — | — |
| Common stock, \$0.01 par value: 6,000,000,000 authorized; 501,891,243 and 501,891,243 shares issued; 480,980,372 and 486,130,461 shares outstanding at September 30, 2018, and December 31, 2017, respectively | 5 | 5 |
| Treasury stock, at cost, 20,910,871 and 15,760,782 shares of common stock at September 30, 2018, and December 31, 2017, respectively | (1,345) | (852) |
| Additional paid-in capital | 1,010 | 1,013 |
| Retained earnings | 3,067 | 2,109 |
| Accumulated other comprehensive loss | (619) | (505) |
| Total Zoetis Inc. equity | 2,118 | 1,770 |
| Equity attributable to noncontrolling interests | — | 16 |
| Total equity | 2,118 | 1,786 |

| | | |
|------------------------------|-----------|----------|
| Total liabilities and equity | \$ 10,459 | \$ 8,586 |
|------------------------------|-----------|----------|

(a) As of September 30, 2018, and December 31, 2017, includes \$5 million and \$6 million, respectively, of restricted cash.

See notes to condensed consolidated financial statements.

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

| | Zoetis | | | | Accumulated Equity | | | Total Equity |
|--|-----------------------------|-------------------------------|-----------------|-------------------|--------------------------|--------------------------|-----------------|--------------|
| | Common Stock ^(a) | Treasury Stock ^(a) | Paid-in Capital | Retained Earnings | Other Comprehensive Loss | Noncontrolling Interests | Attributable to | |
| (MILLIONS OF DOLLARS) | | | | | | | | |
| Balance, December 31, 2016 | \$ 5 | \$(421) | \$ 1,024 | \$ 1,477 | \$ (598) | \$ 12 | | \$ 1,499 |
| Nine months ended October 1, 2017 | | | | | | | | |
| Net income | — | — | — | 783 | — | (1) | | 782 |
| Other comprehensive income | — | — | — | — | 143 | 1 | | 144 |
| Consolidation of a noncontrolling interest ^(b) | — | — | — | — | — | 18 | | 18 |
| Share-based compensation awards ^(c) | — | 63 | 6 | (17) | — | — | | 52 |
| Treasury stock acquired ^(d) | — | (375) | — | — | — | — | | (375) |
| Employee benefit plan contribution from Pfizer Inc. ^(e) | — | — | 2 | — | — | — | | 2 |
| Dividends declared | — | — | — | (103) | — | — | | (103) |
| Balance, October 1, 2017 | \$ 5 | \$(733) | \$ 1,032 | \$ 2,140 | \$ (455) | \$ 30 | | \$ 2,019 |
| Balance, December 31, 2017 | \$ 5 | \$(852) | \$ 1,013 | \$ 2,109 | \$ (505) | \$ 16 | | \$ 1,786 |
| Nine months ended September 30, 2018 | | | | | | | | |
| Net income/(loss) | — | — | — | 1,083 | — | (4) | | 1,079 |
| Other comprehensive loss | — | — | — | — | (114) | — | | (114) |
| Acquisition of a noncontrolling interest ^(b) | — | — | (14) | — | — | (12) | | (26) |
| Share-based compensation awards ^(c) | — | 55 | 9 | (3) | — | — | | 61 |
| Treasury stock acquired ^(d) | — | (548) | — | — | — | — | | (548) |
| Employee benefit plan contribution from Pfizer Inc. ^(e) | — | — | 2 | — | — | — | | 2 |
| Dividends declared | — | — | — | (122) | — | — | | (122) |
| Balance, September 30, 2018 | \$ 5 | \$(1,345) | \$ 1,010 | \$ 3,067 | \$ (619) | \$ — | | \$ 2,118 |

As of September 30, 2018, and October 1, 2017, there were 480,980,372 and 487,832,003 outstanding shares of
 (a) common stock, respectively, and 20,910,871 and 14,059,240 shares of treasury stock, respectively. Treasury stock is recognized at the cost to reacquire the shares. For additional information, see Note 14. Stockholders' Equity.

For the nine months ended October 1, 2017, represents the consolidation of a European livestock monitoring company. For the nine months ended September 30, 2018, represents the acquisition of the noncontrolling interest of a European livestock monitoring company.
 (b)

Includes the issuance of shares of Zoetis Inc. common stock and the reissuance of treasury stock in connection with the vesting of employee share-based awards. Upon reissuance of treasury stock, differences between the proceeds from reissuance and the cost of the treasury stock that result in gains are recorded in Additional paid-in capital.

Losses are recorded in Additional paid-in capital to the extent that they can offset previously recorded gains. If no such credit exists, the differences are recorded in Retained earnings. Also includes the reacquisition of shares of treasury stock associated with the vesting of employee share-based awards to satisfy tax withholding requirements and the acquisition date fair value of replacement awards issued in conjunction with the acquisition of Abaxis in 2018 attributable to pre-combination services. For additional information, see Note 5. Acquisitions and Divestitures.
 (c)

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- (d) Reflects the acquisition of treasury shares in connection with the share repurchase program. For additional information, see Note 14. Stockholders' Equity.
- (e) 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.

See notes to condensed consolidated financial statements.

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

| | Nine Months Ended | |
|---|--------------------------|-----------------------|
| | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | |
| Operating Activities | | |
| Net income before allocation to noncontrolling interests | \$1,079 | \$782 |
| Adjustments to reconcile net income before noncontrolling interests to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 207 | 179 |
| Share-based compensation expense | 36 | 33 |
| Asset write-offs and asset impairments | 4 | 1 |
| Net loss on sale of assets | — | 2 |
| Provision for losses on inventory | 37 | 46 |
| Deferred taxes ^(a) | (155) | (3) |
| Employee benefit plan contribution from Pfizer Inc. | 2 | 2 |
| Other non-cash adjustments | (17) | 11 |
| Other changes in assets and liabilities, net of acquisitions and divestitures | | |
| Accounts receivable | 37 | (58) |
| Inventories | 29 | (35) |
| Other assets | (77) | (132) |
| Accounts payable | (39) | (56) |
| Other liabilities | (31) | (107) |
| Other tax accounts, net ^(a) | 94 | 73 |
| Net cash provided by operating activities | 1,206 | 738 |
| Investing Activities | | |
| Purchases of property, plant and equipment | (200) | (141) |
| Acquisition of Abaxis, net of cash acquired | (1,884) | — |
| Other acquisitions | (108) | (82) |
| Net proceeds from sales of assets | 8 | 1 |
| Other investing activities | (1) | 6 |
| Net cash used in investing activities | (2,185) | (216) |
| Financing Activities | | |
| Proceeds from issuance of long-term debt—senior notes, net of discount and fees | 1,485 | 1,231 |
| Payment of contingent consideration related to previously acquired assets | (12) | (5) |
| Acquisition of a noncontrolling interest | (26) | — |
| Share-based compensation-related proceeds, net of taxes paid on withholding shares | 14 | 20 |
| Purchases of treasury stock | (548) | (375) |
| Cash dividends paid | (183) | (155) |
| Net cash provided by financing activities | 730 | 716 |
| Effect of exchange-rate changes on cash and cash equivalents | (29) | 16 |
| Net increase/(decrease) in cash and cash equivalents | (278) | 1,254 |
| Cash and cash equivalents at beginning of period | 1,564 | 727 |
| Cash and cash equivalents at end of period | \$1,286 | \$1,981 |

Supplemental cash flow information

Cash paid during the period for:

| | | |
|---------------------------------------|-------|-------|
| Income taxes | \$290 | \$366 |
| Interest, net of capitalized interest | 166 | 138 |

Non-cash transactions:

| | | |
|--|---|---|
| Purchases of property, plant and equipment | 3 | 6 |
|--|---|---|

Reflects the reclassification of the one-time mandatory deemed repatriation tax from Noncurrent deferred tax

(a) liabilities to Income taxes payable and Other taxes payable to properly reflect the liability, which became a fixed obligation in 2018 payable over eight years.

See notes to condensed consolidated financial statements.

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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 45 countries across North America, Europe, Africa, Asia, Australia and South America. Our products are sold in more than 100 countries, including developed markets and emerging markets. 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 six major product categories: vaccines, anti-infectives, parasiticides, medicated feed additives, animal health diagnostics and other pharmaceuticals.

2. 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 31, 2018, and August 27, 2017.

Prior to fiscal 2018, the company followed a 13-week quarterly accounting cycle for each of the first three fiscal quarters. The company's fiscal year ends on December 31 for our operations in the United States and on November 30 for subsidiaries operating outside the United States. Beginning in fiscal 2018, the company's first three fiscal quarters will end on the last day of March, June and September in the United States and the last day of February, May and August for subsidiaries operating outside the United States. There is no change to the company's fiscal year-end dates. We did not adjust our results of operations for periods prior to 2018 as the impact was not material.

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 2017 Annual Report on Form 10-K.

3. Accounting Standards

Recently Adopted Accounting Standards

In March 2018, the Financial Accounting Standards Board (FASB) issued an accounting standards update to align existing guidance on accounting for income taxes, pursuant to guidance provided by a Staff Accounting Bulletin published by the SEC on December 22, 2017. The update addresses the challenges in accounting for the effects of the Tax Cuts and Jobs Act (the Tax Act), enacted on December 22, 2017, in the period of enactment and required companies to report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date. For additional information, see Note 8. Income Taxes. In August 2017, the FASB issued an accounting standards update which amends the hedge accounting recognition and presentation requirements

and is intended to better align hedge accounting with companies' risk management strategies. The standard eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires that the entire change in fair value of a hedging instrument be presented in the same income statement line item as the respective hedged item. The standard also modifies certain disclosure requirements. The provisions of the update are effective beginning

January 1, 2019 for interim and annual periods with early adoption permitted for any interim period after issuance of the update. We elected to early adopt this guidance as of April 1, 2018. There were no hedging contracts in effect as of the date of adoption.

In March 2017, the FASB issued an accounting standards update to simplify and improve the reporting of net periodic pension benefit cost by requiring only present service cost to be presented in the same line item as other current employee compensation costs while remaining components of net periodic benefit cost would be presented within Other (income)/deductions—net outside of operations. We adopted this guidance as of January 1, 2018, the required effective date. The new standard did not have a significant impact on our consolidated financial statements.

In October 2016, the FASB issued an accounting standards update that requires the recognition of the income tax consequences of an intra-entity asset transfer, other than inventory, when the transfer occurs as opposed to when the asset is sold to an outside third party. We adopted this

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guidance as of January 1, 2018, the required effective date. The new standard did not 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. 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. We adopted this guidance as of January 1, 2018, the required effective date, using the modified retrospective adoption method. Prior period amounts have not been adjusted and continue to be reported in accordance with our historic accounting policies. Application of the standard using the modified retrospective method did not require an adjustment to opening retained earnings. For additional information, see Note 4. Revenue.

Recently Issued Accounting Standards

In August 2018, the FASB issued an accounting standards update which expands the scope of costs associated with cloud computing arrangements that must be capitalized. Under the new guidance, costs associated with implementing a cloud computing arrangement that is a service contract must be capitalized and expensed over the term of the hosting arrangement. The provisions of the update are effective beginning January 1, 2020 for interim and annual periods with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption as well as the potential impact that the standard will have on our consolidated financial statements.

In February 2018, the FASB issued an accounting standards update which permits companies to reclassify from accumulated other comprehensive income to retained earnings stranded tax effects resulting from the new federal corporate income tax rate. In the period of adoption, a company may choose to either apply the amendments retrospectively to each period in which the effect of the change in federal income tax rate is recognized or to apply the amendments in that reporting period. The provisions of the update are effective beginning January 1, 2019 for interim and annual periods, with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption and do not expect that the new standard will have a significant impact on our consolidated financial statements.

In February 2016, the FASB issued an accounting standards update which requires lessees to recognize most leases on the balance sheet with a corresponding right of use asset. Leases will be classified as financing or operating which will drive the expense recognition pattern. For lessees, the income statement presentation and expense recognition pattern for financing and operating leases is similar to the current model for capital and operating leases, respectively. Companies may elect to exclude short-term leases. The update also requires additional disclosures that will better enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We plan to adopt this guidance as of January 1, 2019, using the effective date as the date of initial application. As permitted, utilizing an optional transition method, a cumulative-effect adjustment to the opening balance of retained earnings will be recognized in the period of adoption, and financial information and disclosure for periods prior to the date of initial application will not be updated. We have selected a lease accounting system which we are in the process of implementing, while continuing to evaluate our lease contracts, accounting policy elections, and the impact of adoption on our consolidated financial statements. While we do not expect adoption of the standard to have a significant impact on our consolidated statements of income, the impact on the assets and liabilities within our consolidated balance sheet will be material.

4. Revenue

A. Revenue from Product Sales

We offer a diversified portfolio of products which allows us to capitalize on local and regional customer needs. Generally, our products are promoted to veterinarians and livestock producers by our sales organization which includes sales representatives and technical and veterinary operations specialists, and then sold directly by us or through distributors. The depth of our product portfolio enables us to address the varying needs of customers in different species and geographies. Many of our top selling product lines are distributed across both of our operating segments, leveraging our R&D operations and manufacturing and supply chain network.

Over the course of our history, we have focused on developing a diverse portfolio of animal health products, including medicines and vaccines, complemented by biodevices, diagnostics, and genetics. We refer to a single product in all brands, or its dosage forms for all species, as a product line. We have approximately 300 comprehensive product lines, including products for both livestock and companion animals across each of our major product categories.

In the third quarter of 2018, the company modified the list of major product categories to include a category for animal health diagnostics, which was previously included within other non-pharmaceutical products. The prior period presentation has been revised to reflect the new product categories.

Our major product categories are:

• vaccines: biological preparations that help prevent diseases of the respiratory, gastrointestinal and reproductive tracts or induce a specific immune response;

• anti-infectives: products that prevent, kill or slow the growth of bacteria, fungi or protozoa;

• other pharmaceutical products: allergy and dermatology, pain and sedation, antiemetic, reproductive, and oncology products;

• parasiticides: products that prevent or eliminate external and internal parasites such as fleas, ticks and worms;

• medicated feed additives: products added to animal feed that provide medicines to livestock; and

• animal health diagnostics: portable blood and urine analysis systems and point-of-care diagnostic products, including instruments

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and reagents, rapid immunoassay tests, reference laboratory kits and blood glucose monitors.

Our remaining revenue is derived from other non-pharmaceutical product categories, such as nutritionals and agribusiness, as well as products and services in complementary areas, including biodevices and genetics.

Our livestock products primarily help prevent or treat diseases and conditions to enable the cost-effective production of safe, high-quality animal protein. Human population growth and increasing standards of living are important long-term growth drivers for our livestock products in three major ways. First, population growth and increasing standards of living drive increased demand for improved nutrition, particularly animal protein. Second, population growth leads to increased natural resource constraints driving a need for enhanced productivity. Finally, as standards of living improve, there is increased focus on food quality and safety.

Our companion animal products help extend and improve the quality of life for pets; increase convenience and compliance for pet owners; and help veterinarians improve the quality of their care and the efficiency of their businesses. Growth in the companion animal medicines and vaccines sector is driven by economic development, related increases in disposable income and increases in pet ownership and spending on pet care. Companion animals are also living longer, receiving increased medical treatment and benefiting from advances in animal health medicines and vaccines.

The following tables present our revenue disaggregated by geographic area, species, and major product category.

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Revenue by geographic area

| | Three Months Ended | | Nine Months Ended | |
|-------------------------|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| United States | \$757 | \$680 | \$2,068 | \$1,908 |
| Australia | 53 | 51 | 152 | 134 |
| Brazil | 72 | 66 | 210 | 205 |
| Canada | 42 | 40 | 138 | 123 |
| China | 46 | 40 | 170 | 137 |
| France | 29 | 30 | 92 | 85 |
| Germany | 36 | 35 | 112 | 96 |
| Italy | 27 | 22 | 80 | 65 |
| Japan | 34 | 31 | 114 | 101 |
| Mexico | 24 | 21 | 74 | 60 |
| Spain | 28 | 24 | 83 | 67 |
| United Kingdom | 47 | 36 | 135 | 105 |
| Other developed markets | 98 | 96 | 266 | 240 |
| Other emerging markets | 173 | 162 | 537 | 485 |
| | 1,466 | 1,334 | 4,231 | 3,811 |

| | | | | |
|---|----|----|----|----|
| Contract manufacturing & human health diagnostics | 14 | 13 | 30 | 36 |
|---|----|----|----|----|

| | | | | |
|---------------|---------|---------|---------|---------|
| Total Revenue | \$1,480 | \$1,347 | \$4,261 | \$3,847 |
|---------------|---------|---------|---------|---------|

Revenue by major species

| | Three Months Ended | | Nine Months Ended | |
|-----------------------|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| U.S. | | | | |
| Livestock | \$322 | \$319 | \$885 | \$870 |
| Companion animal | 435 | 361 | 1,183 | 1,038 |
| | 757 | 680 | 2,068 | 1,908 |
| International | | | | |
| Livestock | 456 | 435 | 1,397 | 1,276 |
| Companion animal | 253 | 219 | 766 | 627 |
| | 709 | 654 | 2,163 | 1,903 |

| | | | | |
|---|----|----|----|----|
| Contract manufacturing & human health diagnostics | 14 | 13 | 30 | 36 |
|---|----|----|----|----|

| | | | | |
|---------------|---------|---------|---------|---------|
| Total Revenue | \$1,480 | \$1,347 | \$4,261 | \$3,847 |
|---------------|---------|---------|---------|---------|

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Revenue by species

| | Three Months | | Nine Months | |
|---|--------------|---------|-------------|---------|
| | Ended | | Ended | |
| | September | October | September | October |
| | 30, | 1, | 30, | 1, |
| (MILLIONS OF DOLLARS) | 2018 | 2017 | 2018 | 2017 |
| Livestock: | | | | |
| Cattle | \$417 | \$424 | \$1,229 | \$1,192 |
| Swine | 160 | 147 | 500 | 455 |
| Poultry | 130 | 119 | 395 | 357 |
| Fish | 46 | 39 | 92 | 79 |
| Other | 25 | 25 | 66 | 63 |
| | 778 | 754 | 2,282 | 2,146 |
| Companion Animal: | | | | |
| Dogs and Cats | 653 | 546 | 1,832 | 1,561 |
| Horses | 35 | 34 | 117 | 104 |
| | 688 | 580 | 1,949 | 1,665 |
| Contract manufacturing & human health diagnostics | 14 | 13 | 30 | 36 |
| Total Revenue | \$1,480 | \$1,347 | \$4,261 | \$3,847 |

Revenue by major product category

| | Three Months | | Nine Months | |
|---|--------------|---------|-------------|---------|
| | Ended | | Ended | |
| | September | October | September | October |
| | 30, | 1, | 30, | 1, |
| (MILLIONS OF DOLLARS) | 2018 | 2017 | 2018 | 2017 |
| Vaccines | \$382 | \$363 | \$1,109 | \$1,006 |
| Anti-infectives | 323 | 324 | 906 | 870 |
| Other pharmaceuticals | 361 | 304 | 1,017 | 858 |
| Parasiticides | 203 | 191 | 639 | 581 |
| Medicated feed additives | 111 | 107 | 362 | 351 |
| Animal health diagnostics | 46 | 11 | 69 | 32 |
| Other non-pharmaceuticals | 40 | 34 | 129 | 113 |
| | 1,466 | 1,334 | 4,231 | 3,811 |
| Contract manufacturing & human health diagnostics | 14 | 13 | 30 | 36 |
| Total Revenue | \$1,480 | \$1,347 | \$4,261 | \$3,847 |

B. Revenue Accounting Policy

Below are the significant accounting policies updated as of January 1, 2018 as a result of the adoption of the new revenue recognition guidance. For additional information, see Note 3. Accounting Standards.

We recognize revenue from product sales when control of the goods has transferred to the customer, which is typically once the goods have shipped and the customer has assumed title. Revenue reflects the total consideration to which we expect to be entitled (i.e. the transaction price), in exchange for products sold, after considering various types of variable consideration including rebates, sales allowances, product returns and discounts.

Variable consideration is estimated and recorded at the time that related revenue is recognized. Our estimates reflect the amount by which we expect variable consideration to impact revenue recognized and are generally based on contractual terms or historical experience, adjusted as necessary to reflect our expectations about the future. Our

customer payment terms generally range from 45 to 75 days.

Estimates of variable consideration utilize a complex series of judgments and assumptions to determine the amount by which we expect revenue to be reduced, for example;

for sales returns, we perform calculations in each market that incorporate the following, as appropriate: local returns policies and practices; historic returns as a percentage of revenue; estimated shelf life by product; an estimate of the amount of time between shipment and return or lag time; and any other factors that could impact the estimate of future returns, product recalls, discontinuation of products or a changing competitive environment; and

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for revenue incentives, we use our historical experience with similar incentives programs to estimate the impact of such programs on revenue for the current period.

Although the amounts recorded for these revenue deductions are dependent on estimates and assumptions, historically our adjustments to actual results have not been material. The sensitivity of our estimates can vary by program, type of customer and geographic location.

A deferral of revenue may be required in the event that we have not satisfied all customer obligations for which we have been compensated. The transaction price is allocated to the individual performance obligations on the basis of relative stand-alone selling price, which is typically based on actual sales prices. Revenue associated with unsatisfied performance obligations are contract liabilities, is recorded within Other current liabilities, and is recognized once control of the underlying products has transferred to the customer. Contract liabilities reflected within Other current liabilities as of the adoption date and subsequently recognized as revenue during the first nine months of 2018 were approximately \$2 million. Contract liabilities as of September 30, 2018 were approximately \$7 million.

We do not disclose the transaction price allocated to unsatisfied performance obligations related to contracts with an original expected duration of one year or less, or for contracts for which we recognize revenue in line with our right to invoice the customer. Estimated future revenue expected to be generated from long-term contracts with unsatisfied performance obligations as of September 30, 2018 is insignificant.

Taxes collected from customers relating to product sales and remitted to governmental authorities are excluded from Revenue. Shipping and handling costs incurred after control of the purchased product has transferred to the customer are accounted for as a fulfillment cost, within Selling, general and administrative expenses.

5. Acquisitions and Divestitures

Acquisition of Abaxis, Inc.

On July 31, 2018, we completed the acquisition of Abaxis, Inc. (Abaxis), a California corporation and a leader in the development, manufacture and marketing of diagnostic instruments for veterinary point-of-care services. We acquired all of the outstanding common shares of Abaxis for \$83.00 per share in cash resulting in Abaxis becoming our wholly owned subsidiary. The acquisition enhances our presence in veterinary diagnostics.

The acquisition date fair value of the consideration transferred was approximately \$1,962 million, which consisted of the following:

| (MILLIONS OF DOLLARS) | Amounts |
|--|----------|
| Cash paid to Abaxis' shareholders ^(a) | \$ 1,898 |
| Cash paid for equity awards attributable for pre-merger services ^(b) | 54 |
| Fair value of Zoetis equity awards issued in exchange for outstanding Abaxis equity awards pertaining to pre-merger service ^(c) | 10 |
| Total consideration | \$ 1,962 |

^(a) Represents cash paid for cancellation and conversion of each outstanding share of Abaxis' common stock at the acquisition date.

^(b) Represents cash paid for cancellation and settlement of restricted stock awards that fully vested in July 2018 as a result of service or pre-existing change-in-control provisions and termination provisions. Includes certain awards that will be settled in cash during 2019, reflected in Other current liabilities within the condensed consolidated balance sheet.

^(c) Represents the fair value of replacement awards issued for Abaxis equity awards outstanding immediately before the acquisition and attributable to the service period prior to the acquisition. The previous Abaxis equity awards were converted into the Zoetis equity awards at an exchange ratio based on the closing prices of shares of Zoetis Common Stock and Abaxis Common Stock for ten full trading days before the closing of the acquisition.

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The acquisition has been accounted for as a business combination with the assets acquired and liabilities assumed measured at estimated fair values as of the acquisition date, primarily using Level 3 inputs, except for investments in debt securities which were valued using Level 2 inputs.

The table below presents the preliminary fair values allocated to Abaxis' assets and liabilities as of the acquisition date.

| (MILLIONS OF DOLLARS) | Amounts |
|--|----------|
| Cash and cash equivalents | \$ 64 |
| Short term investments ^(a) | 107 |
| Accounts receivable ^(b) | 30 |
| Inventories ^(c) | 79 |
| Other current assets | 6 |
| Property, plant and equipment ^(d) | 49 |
| Identifiable intangible assets ^(e) | 898 |
| Other noncurrent assets | 29 |
| Accounts payable | (21) |
| Accrued compensation and related items | (10) |
| Other current liabilities | (26) |
| Other noncurrent liabilities | (11) |
| Noncurrent deferred tax liabilities ^(f) | (215) |
| Total net assets acquired | 979 |
| Goodwill ^(g) | 983 |
| Total consideration | \$ 1,962 |

(a) Short term investments include investments in debt securities that are classified as available-for-sale and measured at fair value.

(b) The fair value approximates the gross contractual amount of accounts receivable. The contractual amount not expected to be collected is immaterial.

Acquired inventory is comprised of finished goods, work in process and raw materials. The preliminary estimate of fair value of finished goods was determined based on net realizable value adjusted for the costs of the selling effort, a reasonable profit allowance for the selling effort, and estimated holding costs. The preliminary estimate of fair

(c) value of work in process was determined based on net realizable value adjusted for costs to complete the manufacturing process, costs of the selling effort, a reasonable profit allowance for the remaining manufacturing and selling effort, and an estimate of holding costs. The fair value of raw materials was determined to approximate book value.

(d) Property, plant and equipment is comprised of machinery and equipment, furniture and fixtures, computer equipment, leasehold improvements and construction in progress. The preliminary estimated fair value was primarily determined using a reproduction/replacement cost approach which measures the value of an asset by estimating the cost to acquire or construct comparable assets adjusted for age and condition of the asset.

(e) Identifiable intangible assets primarily consist of developed technology rights, customer relationships, and trademarks and tradenames. The preliminary estimate of fair value of identifiable intangible assets is determined using the income approach, which includes a forecast of expected future cash flows. For additional information regarding identifiable intangible assets, see Note 11. Goodwill and Other Intangible Assets.

The acquisition was structured as a stock purchase and therefore we assumed the historical tax basis of Abaxis' assets and liabilities. The preliminary estimate of deferred tax effects resulting from the acquisition include the (f) expected federal, state, and foreign tax consequences associated with temporary differences between the preliminary fair values of the assets acquired and liabilities assumed and the respective tax basis. The components of the Abaxis net deferred tax liability are included within amounts reported in Note 8. Income Taxes.

(g) Goodwill represents the excess of consideration transferred over the preliminary estimate of fair values of the assets acquired and liabilities assumed. It is allocated to our existing reportable segments and is primarily attributable to the future potential of the technology platforms, as well as cost and revenue synergies including

market share capture, elimination of cost redundancies and gain of cost efficiencies, and intangible assets such as assembled workforce which are not separately recognizable. The primary strategic purpose of the acquisition was to enhance the company's existing product portfolio by strengthening Zoetis' presence in veterinary diagnostics. The goodwill recorded is not deductible for tax purposes. The allocation of goodwill to the reporting units is preliminary and will be completed as the company obtains the information necessary to complete the analysis, but no later than one year from the date of the acquisition.

All amounts recorded are subject to final valuation. Any adjustments to our preliminary purchase price allocation identified during the measurement period, which will not exceed one year from the acquisition date, will be accounted for prospectively.

The company incurred acquisition related costs of approximately \$39 million and \$40 million for the three and nine months ended September 30, 2018, respectively, which are included within Restructuring charges/(reversals) and certain acquisition-related costs and Selling, general and administrative expenses on our condensed consolidated statements of income.

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The following table presents information for Abaxis' operations from the acquisition date through September 30, 2018 which are included in our condensed consolidated statements of income for the three months ended September 30, 2018:

| | |
|---|---------------------------------------|
| | July 31 - September 30, 2018 |
| (MILLIONS OF DOLLARS) | |
| Revenue | \$ 42 |
| Net loss attributable to Zoetis Inc. ^(a) | 32 |

Included in the net loss are (i) \$7 million of cost of goods sold related to the preliminary fair value adjustment for acquisition date inventory estimated to have been sold during the period ended September 30, 2018, (ii) \$20

(a) million of amortization expense related to the preliminary fair value of identifiable intangible assets recognized at the acquisition date, (iii) \$10 million of severance costs directly related to the acquisition, and (iv) the applicable tax impact of above adjustments based on the statutory tax rates in the various jurisdictions where the adjustments are expected to be incurred.

Supplemental Pro Forma Information:

The following table provides unaudited supplemental pro forma financial information as if the acquisition of Abaxis had occurred on January 1, 2017.

| (MILLIONS OF DOLLARS, EXCEPT PER SHARE DATA) | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| Revenue | \$1,500 | \$1,406 | \$4,416 | \$4,022 |
| Net income attributable to Zoetis Inc. | 348 | 267 | 1,024 | 665 |
| Net income per common share - basic | 0.72 | 0.55 | 2.12 | 1.35 |
| Net income per common share - diluted | 0.72 | 0.54 | 2.10 | 1.35 |

The supplemental pro forma financial information has been prepared using the acquisition method of accounting and is based on the historical financial information of Zoetis and Abaxis. The supplemental pro forma financial information does not necessarily represent what the combined company's revenue or results of operations would have been had the acquisition been completed on January 1, 2017, nor do they intend to be a projection of future operating results of the combined company. It also does not reflect any operating efficiencies or potential cost savings that might be achieved from synergies of combining Zoetis and Abaxis.

The unaudited supplemental pro forma financial information reflect primarily the following pro forma adjustments: Acquisition related costs incurred by Zoetis and Abaxis of \$57 million and \$60 million have been removed for each of the three and nine months ended September 30, 2018, respectively. Acquisition related costs of \$0 million and \$38 million are assumed to be have been incurred during the three and nine months ended October 1, 2017, respectively. Additional amortization expense of \$13 million and \$78 million for each of the three and nine months ended September 30, 2018, respectively, and \$33 million and \$98 million for each of the three and nine months ended October 1, 2017, respectively, related to the preliminary fair value estimate of identified intangible assets acquired. Additional depreciation expense of \$1 million for the nine months ended September 30, 2018, and \$1 million for the nine months ended October 1, 2017, related to the preliminary estimate of fair value adjustments to property, plant and equipment acquired.

Adjustments related to the preliminary estimate of the non-recurring fair value adjustment to acquisition date inventory estimated to have been sold, resulting in \$7 million removed for each of the three and nine months ended September 30, 2018, respectively, and \$11 million and \$33 million added to the three and nine months ended October 1, 2017, respectively.

Additional interest expense and amortization of debt issuance costs for the debt issuance to finance the acquisition, resulting in \$8 million and \$36 million added for the three and nine months ended September 30, 2018, respectively,

and \$14 million and \$43 million added to the three and nine months ended October 1, 2017, respectively.

Adjustments related to the post merger share-based compensation expense of the replacement awards are \$0 million and \$7 million for the three and nine months ended September 30, 2018, respectively, and \$3 million and \$10 million for the three and nine months ended October 1, 2017, respectively.

- Applicable tax impact of the above adjustments based on the statutory tax rates in the various jurisdictions where the adjustments are expected to be incurred.

Other Acquisitions

In the third quarter of 2018, we completed the acquisition of a manufacturing business in Ireland and the noncontrolling interest of a European livestock monitoring company. These transactions did not have a significant impact on our consolidated financial statements.

Divestitures

On May 11, 2017, we completed the sale of our manufacturing site in Shenzhou, China. We had previously exited operations at this site during the second quarter of 2015 as part of our operational efficiency program. We received total cash proceeds of approximately \$3 million and recorded a net pre-tax gain of approximately \$2 million within Other (income)/deductions—net.

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Additionally, in the second quarter of 2017, we recorded a \$4 million expense within Other (income)/deductions—net related to the February 12, 2016 sale of two of our manufacturing sites in the United States: Laurinburg, North Carolina, and Longmonth, Colorado to Huvepharma NV (Huvepharma), a European animal health company.

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.

During 2015, we launched a comprehensive operational efficiency program, which was incremental to the previously announced supply network strategy. These initiatives focused on reducing complexity in our product portfolios, changing our selling approach in certain markets, reducing our presence in certain countries, and exiting manufacturing sites over a long term period. We have also continued to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing activities and operating more efficiently as a result of less internal complexity and more standardization of processes. The comprehensive operational efficiency program was substantially completed as of December 31, 2017. We expect to complete the supply network strategy over the next several years.

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Restructuring charges/(reversals) and certain acquisition-related costs: | | | | |
| Transaction costs ^(a) | \$ 21 | \$ — | \$ 21 | \$ — |
| Integration costs ^(b) | 9 | 2 | 10 | 4 |
| Restructuring charges/(reversals) ^{(c)(d)} : | | | | |
| Employee termination costs | 17 | 7 | 22 | 3 |
| Exit costs | — | (1) | 1 | — |
| Total Restructuring charges/(reversals) and certain acquisition-related costs | \$ 47 | \$ 8 | \$ 54 | \$ 7 |

(a) Transaction costs represent external costs directly related to acquiring businesses and primarily include expenditures for banking, legal, accounting and other similar services.

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.

(c) The restructuring charges for the three months ended September 30, 2018, are primarily related to: employee termination costs of \$8 million in Europe as a result of initiatives to better align our organizational structure, and employee termination costs of \$10 million related to the acquisition of Abaxis.

The restructuring charges for the nine months ended September 30, 2018, are primarily related to:

employee termination costs of \$11 million in Europe as a result of initiatives to better align our organizational structure, and

employee termination costs of \$10 million related to the acquisition of Abaxis.

The restructuring charges/(reversals) for the three months ended October 1, 2017, are primarily related to: employee termination costs of \$3 million related to the operational efficiency initiative and supply network strategy, and

employee termination costs of \$4 million related to the acquisition of an Irish biologic therapeutics company in the third quarter of 2017.

The restructuring charges/(reversals) for the nine months ended October 1, 2017, are primarily related to:

employee termination costs of \$4 million related to the acquisition of an Irish biologic therapeutics company in the third quarter of 2017.

(d) The restructuring charges/(reversals) are associated with the following:

For the three months ended September 30, 2018, International of \$8 million and Manufacturing/research/corporate of \$9 million.

For the nine months ended September 30, 2018, International of \$12 million and Manufacturing/research/corporate of \$11 million.

For the three months ended October 1, 2017, International of (\$1 million reversal) and Manufacturing/research/corporate of \$7 million.

For the nine months ended October 1, 2017, International of (\$2 million reversal) and Manufacturing/research/corporate of \$5 million.

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Charges related to the operational efficiency initiative and supply network strategy are as follows:

| | Three Months Ended September 30, 2018 | | Nine Months Ended October 30, 2017 | |
|--|--|------|---|-------|
| (MILLIONS OF DOLLARS) | | | | |
| Restructuring charges/(reversals) and certain acquisition-related costs: | | | | |
| Operational efficiency initiative | | | | |
| Employee termination costs | \$ (1) | \$ 1 | \$ — | \$ 2 |
| Exit costs | — | (1) | — | — |
| | (1) | — | — | 2 |
| Supply network strategy: | | | | |
| Employee termination costs | — | 2 | 1 | (3) |
| Exit costs | — | — | 1 | — |
| | — | 2 | 2 | (3) |
| Total restructuring charges/(reversals) related to the operational efficiency initiative and supply network strategy | (1) | 2 | 2 | (1) |
| Other operational efficiency initiative charges | | | | |
| Selling, general and administrative expenses: | | | | |
| Consulting fees | — | — | — | 1 |
| Other (income)/deductions—net: | | | | |
| Net (gain)/loss on sale of assets | — | (1) | — | 1 |
| Total other operational efficiency initiative charges | — | (1) | — | 2 |
| Other supply network strategy charges | | | | |
| Cost of sales: | | | | |
| Accelerated depreciation | — | — | — | 2 |
| Consulting fees and other costs | 1 | 1 | 4 | 3 |
| Other (income)/deductions—net: | | | | |
| Net loss on sale of assets ^(a) | 2 | 5 | 2 | 5 |
| Total other supply network strategy charges | 3 | 6 | 6 | 10 |
| Total charges associated with the operational efficiency initiative and supply network strategy | \$ 2 | \$ 7 | \$ 8 | \$ 11 |

For the three and nine months ended October 1, 2017, represents charges related to the agreement to sell a manufacturing site in Guarulhos, Brazil, which includes a \$3 million charge to reduce the carrying value of the disposal group to an amount equal to fair value, less costs to sell, as well as \$2 million of costs related to the anticipated disposal.

The components of, and changes in, our restructuring accruals are as follows:

| | Employee Termination Costs | | Exit Costs | | Accrual |
|--|----------------------------------|---|---------------|--|---------|
| (MILLIONS OF DOLLARS) | | | | | |
| Balance, December 31, 2017 ^(a) | \$ 41 | | \$ — | | \$ 41 |
| Provision | 22 | | 1 | | 23 |
| Utilization and other ^(b) | (26 |) | (1) | | (27) |
| Balance, September 30, 2018 ^(a) | \$ 37 | | \$ — | | \$ 37 |

- (a) At September 30, 2018, and December 31, 2017, included in Accrued expenses (\$15 million and \$19 million, respectively) and Other noncurrent liabilities (\$22 million and \$22 million, respectively).
- (b) Includes adjustments for foreign currency translation.

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7. Other (Income)/Deductions—Net

The components of Other (income)/deductions—net are as follows:

| | Three Months | | Nine Months | |
|---|--------------------|-----------------|--------------------|-----------------|
| | Ended | | Ended | |
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Royalty-related income | \$ (5) | \$ (7) | \$ (18) | \$ (19) |
| Interest income | (6) | (3) | (20) | (8) |
| Net (gain)/loss on sale of assets ^(a) | 2 | 4 | 2 | 6 |
| Certain legal and other matters, net ^(b) | — | — | — | (4) |
| Foreign currency loss ^(c) | 9 | 7 | 26 | 17 |
| Other, net ^(d) | (19) | — | (18) | (3) |
| Other (income)/deductions—net | \$(19) | \$ 1 | \$(28) | \$ (11) |

(a) Represents net losses related to sales of certain manufacturing sites and products as part of our operational efficiency initiative and supply network strategy.

(b) For the nine months ended October 1, 2017, represents income associated with an insurance recovery related to commercial settlements in Mexico recorded in 2014 and 2016.

(c) Primarily driven by costs related to hedging and exposures to certain emerging market currencies.

(d) For the three and nine months ended September 30, 2018, primarily includes a net gain related to the relocation of a manufacturing site in China. For the nine months ended October 1, 2017, primarily includes a settlement refund and reimbursement of legal fees related to costs incurred by Pharmaq prior to the acquisition in 2015 and income associated with certain state business employment tax incentive credits.

8. Income Taxes

A. Taxes on Income

On December 22, 2017, the Tax Act was enacted which, among other changes, reduced the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018. The Tax Act made broad and complex changes to the U.S. tax code and it will take time to fully analyze the impact of the changes. Based on the information available at that time, and the current interpretation of the Tax Act, for the year ended December 31, 2017 the company was able to make a reasonable estimate and recorded an initial provisional net tax expense of \$212 million related to the one-time mandatory deemed repatriation tax, payable over eight years, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. Pursuant to the Staff Accounting Bulletin published by the SEC on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date (measurement-period adjustment). Pursuant to this guidance, the estimated impact of the Tax Act was based on a preliminary review of the new tax law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections.

Our accounting for the following elements of the Tax Act is incomplete. However, in 2018 we were able to further refine our initial reasonable estimate and adjusted the initial provisional net tax expense of \$212 million. We recorded the following measurement-period adjustments of \$23 million and \$58 million net tax benefit during the three and nine months ended September 30, 2018, respectively:

One-Time Mandatory Deemed Repatriation Tax: The one-time mandatory deemed repatriation tax is imposed on previously untaxed accumulated and current earnings and profits (E&P) of our foreign subsidiaries. We were able to reasonably estimate the one-time mandatory deemed repatriation tax and recorded an initial provisional tax obligation, with a corresponding adjustment to income tax expense for the year ended December 31, 2017. We are continuing to gather additional information to more precisely compute the amount of the one-time mandatory deemed repatriation tax. Our accounting for this item is not yet complete due to the fact that the non-U.S. subsidiaries are on a fiscal year

ending November 30, and this tax liability will not become a fixed obligation until November 30, 2018. The estimated impact of the Tax Act is based on a preliminary review of the new law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections. However, on the basis of revised computations that were calculated during the reporting period, we recognized a measurement-period adjustment of \$23 million and \$58 million for the three and nine months ended September 30, 2018, respectively, as a decrease to the one-time mandatory deemed repatriation tax obligation, with a corresponding adjustment to income tax benefit during the period. The effect of the measurement-period adjustment to the three and nine months ended September 30, 2018 effective tax rate was a reduction to the rate of approximately 5.4% and 4.6%, respectively. In addition, we reclassified the one-time mandatory deemed repatriation tax from Noncurrent deferred tax liabilities to Income taxes payable and Other taxes payable. We expect to complete our accounting within the prescribed measurement period.

Reduction of U.S. Federal Corporate Tax Rate: The Tax Act reduced the corporate tax rate to 21%, effective January 1, 2018. Consequently, we recorded a decrease related to deferred tax assets and liabilities with a corresponding net adjustment to deferred income tax benefit for the year ended December 31, 2017. We have not made any measurement-period adjustments related to this item during the nine months of 2018. Since the company has recorded provisional amounts related to certain portions of the Tax Act, any

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corresponding deferred tax remeasurement is also provisional. However, we are continuing to gather additional information to complete our accounting for this item and expect to be completed within the prescribed measurement period.

Valuation Allowances: The company must assess whether its valuation allowance analyses are affected by the various aspects of the Tax Act (e.g., one-time mandatory deemed repatriation of deferred foreign income, global intangible low-taxed income inclusions, and new categories of foreign tax credits). We have not made any measurement-period adjustments related to this item during the nine months of 2018. Since the company has recorded provisional amounts related to certain portions of the Tax Act, any corresponding determination of the need for or change in a valuation allowance is also provisional. However, we are continuing to gather additional information to complete our accounting for this item and expect to be completed within the prescribed measurement period.

Global Intangible Low-Taxed Income (GILTI) Policy Election: The GILTI provisions of the Tax Act do not apply to the company until 2019, due to the fact that the non-U.S. subsidiaries are on a fiscal year ending November 30, and we are still evaluating its impact. The FASB allows companies to adopt an accounting policy to either recognize deferred taxes for GILTI or treat such tax cost as a current-period expense when incurred. We have not yet determined our accounting policy because determining the impact of the GILTI provisions requires analysis of our existing legal entity structure, the reversal of our U.S. GAAP and U.S. tax basis differences in the assets and liabilities of our foreign subsidiaries, and our ability to offset any tax with foreign tax credits. As such, we have not made a policy decision whether to record deferred taxes on GILTI or treat such tax cost as a current-period expense.

The effective tax rate was 17.0% for the three months ended September 30, 2018, compared with 28.3% for the three months ended October 1, 2017. The lower effective tax rate for the three months ended September 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a \$23 million net tax benefit recorded in the third quarter of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items; and
- a \$3 million and \$1 million discrete tax benefit recorded in the third quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

The effective tax rate was 15.2% for the nine months ended September 30, 2018, compared with 28.6% for the nine months ended October 1, 2017. The lower effective tax rate for the nine months ended September 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;
- a \$58 million net tax benefit recorded in the nine months ended 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;
- changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;
- a \$12 million and \$8 million discrete tax benefit recorded in the nine months ended 2018 and 2017, respectively, related to the excess tax benefits for share-based payments; and
- an \$8 million and \$3 million discrete tax benefit recorded in the nine months ended 2018 and 2017, respectively, related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

B. Deferred Taxes

As of September 30, 2018, the total net deferred income tax liability of \$373 million is included in Noncurrent deferred tax assets (\$73 million) and Noncurrent deferred tax liabilities (\$446 million).

As of December 31, 2017, the total net deferred income tax liability of \$300 million is included in Noncurrent deferred tax assets (\$80 million) and Noncurrent deferred tax liabilities (\$380 million).

The change in Noncurrent deferred tax liabilities was primarily due to the acquisition of Abaxis, partially offset by the reclassification of the one-time mandatory deemed repatriation tax from Noncurrent deferred tax liabilities to Income taxes payable and Other taxes payable to properly reflect the liability, which became a fixed obligation in 2018, payable over eight years.

C. Tax Contingencies

As of September 30, 2018, the tax liabilities associated with uncertain tax positions of \$184 million (exclusive of interest and penalties related to uncertain tax positions of \$11 million) are included in Noncurrent deferred tax assets (\$4 million) and Other taxes payable (\$180 million).

As of December 31, 2017, the tax liabilities associated with uncertain tax positions of \$164 million (exclusive of interest and penalties related to uncertain tax positions of \$11 million) are included in Noncurrent deferred tax assets (\$3 million) and Other taxes payable (\$161 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

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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 2016, we entered into an amended and restated revolving credit agreement with a syndicate of banks providing for a five-year \$1.0 billion senior unsecured revolving credit facility (the credit facility). In December 2017, the maturity for the amended and restated revolving credit agreement was extended through December 2022. 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. Upon entering into a material acquisition, the maximum total leverage ratio increases to 4.00:1, and extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. The credit facility also contains a clause which adds back to Adjusted Consolidated EBITDA, any operational efficiency restructuring charge (defined as charges recorded by the company during the period commencing on October 1, 2016 and ending December 31, 2019, related to operational efficiency initiatives), provided that for any twelve-month period such charges added back to Adjusted Consolidated EBITDA shall not to exceed \$100 million in the aggregate.

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 30, 2018, and December 31, 2017. There were no amounts drawn under the credit facility as of September 30, 2018, or December 31, 2017.

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 30, 2018, we had access to \$75 million of lines of credit which expire at various times throughout 2018 and 2019 and are generally renewed annually. We did not have any borrowings outstanding related to these facilities as of September 30, 2018, and December 31, 2017.

Commercial Paper Program and Other Short-Term Borrowings

In February 2013, we entered into a commercial paper program with a capacity of up to \$1.0 billion. As of September 30, 2018, and December 31, 2017, there was no commercial paper outstanding under this program. As of September 30, 2018, and December 31, 2017, we did not have any other short-term borrowings outstanding.

Senior Notes and Other Long-Term Debt

On August 20, 2018, we issued \$1.5 billion aggregate principal amount of our senior notes (2018 senior notes), with an original issue discount of \$4 million. These notes are comprised of \$300 million aggregate principal amount of floating rate senior notes due 2021 (the "2018 floating rate senior notes"), and \$300 million aggregate principal amount of 3.250% senior notes due 2021, \$500 million aggregate principal amount of 3.900% senior notes due 2028 and \$400 million aggregate principal amount of 4.450% senior notes due 2048 (collectively, the "2018 fixed rate senior notes"). Net proceeds from this offering were partially used to pay down and terminate a revolving credit agreement and repay outstanding commercial paper, which were borrowed to finance a portion of the cash consideration for the acquisition of Abaxis (see Note 5. Acquisitions and Divestitures). The remainder of the net proceeds will be used for general corporate purposes.

On September 12, 2017, we issued \$1.25 billion aggregate principal amount of our senior notes (2017 senior notes), with an original issue discount of \$7 million. These notes are comprised of \$750 million aggregate principal amount of 3.000% senior notes due 2027 and \$500 million aggregate principal amount of 3.950% senior notes due 2047. Net proceeds from this offering were partially used in October 2017 to repay, prior to maturity, the aggregate principal amount of \$750 million, and a make-whole amount and accrued interest of \$4 million, of our 1.875% senior notes due 2018. The remainder of the net proceeds will be used for general corporate purposes.

On November 13, 2015, we issued \$1.25 billion aggregate principal amount of our senior notes (2015 senior notes), with an original issue discount of \$2 million. On January 28, 2013, we issued \$3.65 billion aggregate principal amount of our senior notes (the 2013 senior notes offering) in a private placement, with an original issue discount of \$10 million.

The 2013, 2015, 2017 and 2018 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 2013, 2015, 2017 and 2018 senior notes may be declared immediately due and payable.

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Pursuant to the indenture, we are able to redeem the 2013, 2015 and 2017 senior notes and the 2018 fixed rate senior notes or 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. The 2018 floating rate senior notes are not redeemable at our option prior to their maturity date. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2013 senior notes due 2023 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 2013, 2015, 2017 and 2018 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 2013, 2015, 2017 and 2018 senior notes at a price equal to 101% of the aggregate principal amount of the 2013, 2015, 2017 and 2018 senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

The components of our long-term debt are as follows:

| | September 30, 2018 | December 31, 2017 |
|--|--------------------------|-------------------------|
| (MILLIONS OF DOLLARS) | | |
| 3.450% 2015 senior notes due 2020 | \$ 500 | \$ 500 |
| 2018 floating rate senior notes due 2021 | 300 | — |
| 3.250% 2018 senior notes due 2021 | 300 | — |
| 3.250% 2013 senior notes due 2023 | 1,350 | 1,350 |
| 4.500% 2015 senior notes due 2025 | 750 | 750 |
| 3.000% 2017 senior notes due 2027 | 750 | 750 |
| 3.900% 2018 senior notes due 2028 | 500 | — |
| 4.700% 2013 senior notes due 2043 | 1,150 | 1,150 |
| 3.950% 2017 senior notes due 2047 | 500 | 500 |
| 4.450% 2018 senior notes due 2048 | 400 | — |
| | 6,500 | 5,000 |
| Unamortized debt discount / debt issuance costs | (59) | (47) |
| Long-term debt, net of discount and issuance costs | \$ 6,441 | \$ 4,953 |

The fair value of our long-term debt was \$6,460 million and \$5,291 million as of September 30, 2018, and December 31, 2017, 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, as of September 30, 2018, matures in the following years:

| | After | | | | | |
|-----------------------|-------|--------|-------|------|----------|---------|
| (MILLIONS OF DOLLARS) | 2019 | 2020 | 2021 | 2022 | 2022 | Total |
| Maturities | \$ | —\$500 | \$600 | \$ | —\$5,400 | \$6,500 |

Interest Expense

Interest expense, net of capitalized interest, was \$54 million and \$147 million, for the three and nine months ended September 30, 2018, respectively, and \$43 million and \$125 million, for the three and nine months ended October 1, 2017, respectively. Capitalized interest expense was \$2 million and \$6 million for the three and nine months ended September 30, 2018, respectively, and \$1 million and \$3 million for the three and nine months ended October 1, 2017, respectively.

B. Investments

As part of the acquisition of Abaxis, we acquired short and long-term investments in debt securities (see Note 5. Acquisitions and Divestitures). These investments are classified as available-for-sale securities and, therefore, are measured at fair value at each reporting date. The changes in fair value are recognized in Accumulated other comprehensive income/(loss). We utilized Level 2 inputs such as observable quoted prices for similar assets and liabilities in active markets and observable quoted prices for identical or similar assets in markets that are not very active.

At September 30, 2018, the investment securities portfolio consisted of debt securities that were virtually all investment grade. Information on investments in the debt securities at September 30, 2018, including the contractual

maturities, or as necessary, the estimated maturities, of the available-for-sale securities is as follows:

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| (MILLIONS OF DOLLARS) | Gross Unrealized | | | Fair Value | Maturities by Period ^(a) | | | |
|------------------------------------|------------------|-------|--------|------------|-------------------------------------|-------------------|--------------|--------|
| | Amortized Cost | Gains | Losses | | Within 1 year | Over 1 to 5 years | Over 5 years | Total |
| Available-for-sale debt securities | | | | | | | | |
| Municipal Bonds | \$1 | \$ — | —\$ | —\$ 1 | \$1 | \$ — | \$ — | —\$1 |
| Corporate Bonds | 117 | — | — | 117 | 104 | 13 | — | 117 |
| Total debt securities | \$118 | \$ — | —\$ | —\$ 118 | \$105 | \$ 13 | \$ — | —\$118 |

^(a) Long term investments are included in Other noncurrent assets.

C. 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 various derivative financial instruments. These derivative financial instruments serve to manage the exposure of our net investment in certain foreign operations to changes in foreign exchange rates and protect net income against the impact of translation into U.S. dollars of certain foreign exchange-denominated transactions.

All derivative financial instruments 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 derivative financial instruments primarily offset exposures in the Australian dollar, Brazilian real, British pound, Canadian dollar, Chinese renminbi, euro, and Norwegian krone. Changes in fair value are reported in earnings or in Accumulated other comprehensive income/(loss), depending on the nature and purpose of the financial instrument, as follows:

For foreign exchange contracts not designated 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.

For cross-currency interest rate swaps, which are designated as a hedge against our net investment in foreign operations, changes in the fair value are deferred as a component of cumulative translation adjustment within Accumulated other comprehensive loss and reclassified into earnings when the foreign investment is sold or substantially liquidated. Gains and losses excluded from the assessment of hedge effectiveness are recognized in earnings (Interest expense—net of capitalized interest). The impact of the periodic exchange of interest payments is reflected within the operating section of our condensed consolidated statement of cash flows.

The aggregate notional amount of foreign exchange derivative financial instruments offsetting foreign currency exposures was \$1.2 billion and \$1.4 billion, as of September 30, 2018, and December 31, 2017, respectively. The vast majority of the foreign exchange derivative financial instruments mature within 60 days and all mature within one year. The aggregate notional amount of cross-currency interest rate swap contracts was 425 million euro as of September 30, 2018, with a term of up to seven years. We did not have any cross-currency interest rate swap contracts as of December 31, 2017.

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. Unrealized gains or losses on the forward-starting interest rate swaps are reported in Accumulated other comprehensive loss and are recognized in earnings 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.

During the third quarter of 2018, we entered into forward starting interest rate swaps with an aggregate notional value of \$350 million. We also entered into treasury lock trades with an aggregate notional value of \$350 million. We designated these swaps and treasury locks (contracts) as cash flow hedges against interest rate exposure related principally to the issuance of fixed-rate debt to be used primarily to fund the acquisition of Abaxis. Upon issuance of our 2018 senior notes (see A. Debt: Senior Notes and Other Long-Term Debt), we terminated these contracts and paid \$1.7 million in cash to the counterparties for settlement. The settlement amount, which represents the fair value of the contracts at the time of termination, was recorded in Accumulated other comprehensive loss, and will be amortized into income over the life of the 2018 senior notes.

There were no outstanding interest rate swap contracts as of September 30, 2018 and December 31, 2017.

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Fair Value of Derivative Instruments

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

| (MILLIONS OF DOLLARS) | Balance Sheet Location | Fair Value of Derivatives | |
|--|---------------------------|------------------------------|----------------------|
| | | September 30, 2018 | December 31, 2017 |
| Derivatives Not Designated as Hedging Instruments | | | |
| Foreign currency forward-exchange contracts | Other current assets | \$ 19 | \$ 10 |
| Foreign currency forward-exchange contracts | Other current liabilities | (6) | (9) |
| Total derivatives not designated as hedging instruments | | \$ 13 | \$ 1 |
| Derivatives Designated as Hedging Instruments: | | | |
| Cross-currency interest rate swap contracts | Other current assets | \$ 3 | \$ — |
| Cross-currency interest rate swap contracts | Other non-current assets | 1 | — |
| Total derivatives designated as hedging instruments | | 4 | — |
| Total derivatives | | \$ 17 | \$ 1 |

The company's cross-currency interest rate swaps are subject to master netting arrangements to mitigate credit risk by permitting net settlement of transactions with the same counterparty. We may also enter into collateral security arrangements with certain of our counterparties to exchange cash collateral when the net fair value of certain derivative instruments fluctuates from contractually established thresholds. At September 30, 2018, there was no collateral posted related to our derivatives.

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

| (MILLIONS OF DOLLARS) | Three Months Ended September 30, 2018 | | Nine Months Ended September 30, 2017 | |
|---|--|-----------|---|-----------|
| Foreign currency forward-exchange contracts | \$ 22 | \$ (17) | \$ 22 | \$ (39) |

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

The amounts of unrecognized net gains/(losses) on derivative instruments designated as cash flow hedges, recorded, net of tax, in Other comprehensive income/(loss), are as follows:

| (MILLIONS OF DOLLARS) | Three Months Ended September 30, 2018 | | Nine Months Ended September 30, 2017 | |
|-----------------------|---|-----------|--|-----------|
| Interest rate swaps | \$ — | \$ (10) | \$ — | \$ (11) |

The amounts of unrecognized net gains/(losses) on cross-currency interest rate swap contracts, recorded, net of tax, in Accumulated other comprehensive income/(loss), are as follows:

| Three Months Ended | Nine Months Ended |
|-----------------------|----------------------|
|-----------------------|----------------------|

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| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
|---|--------------------|-----------------|--------------------|-----------------|
| (MILLIONS OF DOLLARS) | | | | |
| Cross-currency interest rate swap contracts | \$ — | \$ — | \$ 1 | \$ — |

Gains/(losses) on cross-currency interest rate swap contracts, recognized within Interest expense, net of capitalized interest, are as follows:

| | Three Months Ended September 30, 2018 | | Nine Months Ended September 30, 2017 | |
|---|---------------------------------------|------|--------------------------------------|------|
| (MILLIONS OF DOLLARS) | | | | |
| Cross-currency interest rate swap contracts | \$ 2 | \$ — | \$ 3 | \$ — |

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The net amount of deferred gains/(losses) related to derivative instruments designated as cash flow hedges that is expected to be reclassified from Accumulated other comprehensive loss into earnings over the next 12 months is insignificant.

10. Inventories

The components of inventory are as follows:

| | September 30, 2018 | December 31, 2017 |
|----------------------------|--------------------------|-------------------------|
| (MILLIONS OF DOLLARS) | | |
| Finished goods | \$ 785 | \$ 788 |
| Work-in-process | 492 | 484 |
| Raw materials and supplies | 164 | 155 |
| Inventories | \$ 1,441 | \$ 1,427 |

11. Goodwill and Other Intangible Assets

A. Goodwill

The components of, and changes in, the carrying amount of goodwill are as follows:

| (MILLIONS OF DOLLARS) | U.S. | International | Total |
|-----------------------------|---------|---------------|---------|
| Balance, December 31, 2017 | \$671 | \$ 839 | \$1,510 |
| Additions ^(a) | 598 | 433 | 1,031 |
| Other ^(b) | — | (4 |) (4 |
| Balance, September 30, 2018 | \$1,269 | \$ 1,268 | \$2,537 |

^(a) Primarily includes a \$983 million purchase price allocation associated with the acquisition of Abaxis and \$48 million related to the acquisition of a manufacturing business in Ireland. See Note 5. Acquisitions and Divestitures.

^(b) Includes adjustments for foreign currency translation.

The gross goodwill balance was \$3,073 million and \$2,046 million as of September 30, 2018, and December 31, 2017, respectively. Accumulated goodwill impairment losses were \$536 million as of September 30, 2018, and December 31, 2017.

B. Other Intangible Assets

The components of identifiable intangible assets are as follows:

| (MILLIONS OF DOLLARS) | As of September 30, 2018 | | | As of December 31, 2017 | | |
|---|--------------------------|--------------------------------------|-------------------------------------|-------------------------|--------------------------------------|-------------------------------------|
| | Gross | Identifiable Intangible Assets | Less Accumulated Amortization | Gross | Identifiable Intangible Assets | Less Accumulated Amortization |
| Finite-lived intangible assets: | | | | | | |
| Developed technology rights ^{(a)(b)} | \$1,849 | \$ (491 |) \$ 1,358 | \$1,185 | \$ (428 |) \$ 757 |
| Brands | 213 | (152 |) 61 | 213 | (143 |) 70 |
| Trademarks and trade names ^(b) | 166 | (50 |) 116 | 62 | (47 |) 15 |
| Other ^(b) | 413 | (158 |) 255 | 234 | (143 |) 91 |
| Total finite-lived intangible assets | 2,641 | (851 |) 1,790 | 1,694 | (761 |) 933 |
| Indefinite-lived intangible assets: | | | | | | |
| In-process research and development | 219 | — | 219 | 224 | — | 224 |
| Brands | 37 | — | 37 | 37 | — | 37 |
| Trademarks and trade names | 67 | — | 67 | 67 | — | 67 |
| Product rights | 7 | — | 7 | 8 | — | 8 |
| Total indefinite-lived intangible assets | 330 | — | 330 | 336 | — | 336 |
| Identifiable intangible assets | \$2,971 | \$ (851 |) \$ 2,120 | \$2,030 | \$ (761 |) \$ 1,269 |

^(a) Includes the intangible assets related to the acquisition of a manufacturing business in Ireland.

(b) In connection with the acquisition of Abaxis, the company recorded \$898 million of intangible assets, as shown in the table below, representing the preliminary fair value at the acquisition date. See Note 5. Acquisitions and Divestitures for additional information.

| (MILLIONS OF DOLLARS) | Gross Carrying Amount | Weighted-average Life (years) |
|---------------------------------|-----------------------|-------------------------------|
| Finite-lived intangible assets: | | |
| Developed technology rights | \$ 614 | 10 |
| Trademarks and tradenames | 104 | 20 |
| Other | 180 | 4 |
| Total | \$ 898 | |

C. Amortization

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 it benefits 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. Total amortization expense for finite-lived intangible assets was \$45 million and \$96 million for each of the three and nine months ended September 30, 2018, respectively, and \$26 million and \$75 million for each of the three and nine months ended October 1, 2017, respectively.

12. Benefit Plans

Our employees ceased to participate in the Pfizer, Inc. U.S. qualified defined benefit plans and the U.S. retiree medical plan effective December 31, 2012, and liabilities associated with our employees under these plans were retained by Pfizer. Pfizer continued to credit certain employees' service with Zoetis 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 for each of the three month periods ended September 30, 2018, and October 1, 2017, and \$5 million for each of the nine month periods ended September 30, 2018, and October 1, 2017.

The following table provides the net periodic benefit cost associated with our international defined benefit pension plans:

| (MILLIONS OF DOLLARS) | Three Months Ended | | Nine Months Ended | |
|------------------------------------|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| Service cost | \$ 1 | \$ 2 | \$ 5 | \$ 5 |
| Interest cost | 1 | 1 | 2 | 2 |
| Expected return on plan assets | (1) | (1) | (2) | (2) |
| Amortization of net actuarial loss | 1 | — | 1 | 1 |
| Curtailement and settlement loss | — | — | — | 1 |
| Net periodic benefit cost | \$ 2 | \$ 2 | \$ 6 | \$ 7 |

Total company contributions to the international pension plans were \$1 million and \$4 million for the three and nine months ended September 30, 2018, respectively, and \$1 million and \$5 million for the three and nine months ended October 1, 2017, respectively. We expect to contribute a total of approximately \$6 million to these plans in 2018.

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 our 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 units (DSUs), performance-vesting restricted stock units (PSUs) and other equity-based or cash-based

awards.

In connection with the acquisition of Abaxis, in August 2018, the company issued 502,766 restricted stock units (replacement awards) with a weighted average grant date fair value of \$85.26 per RSU, per the terms of the merger agreement between Zoetis and Abaxis, in connection with unvested Abaxis employee equity awards. The Abaxis unvested equity awards were canceled and exchanged for the replacement awards using a conversion ratio stated in the merger agreement. The grant date fair value of the replacement awards that is attributable to pre merger service is \$10 million and is part of the consideration transferred in exchange for the acquisition of Abaxis. The fair value of the replacement awards attributable to post merger service is \$33 million and will be recorded over future vesting periods. The replacement awards vest over varying terms of continuous service up to four years 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. For additional information see Note 5. Acquisitions and Divestitures.

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The components of share-based compensation expense are as follows:

| (MILLIONS OF DOLLARS) | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-------|-------------------|-------|
| | September 30, 2018 | | October 1, 2017 | |
| | 2018 | 2017 | 2018 | 2017 |
| Stock options / stock appreciation rights | \$ 2 | \$ 2 | \$ 7 | \$ 7 |
| RSUs / DSUs ^(a) | 10 | 7 | 23 | 20 |
| PSUs | 2 | 2 | 6 | 6 |
| Share-based compensation expense—total | \$ 14 | \$ 11 | \$ 36 | \$ 33 |

For the three and nine months ended September 30, 2018, includes share-based compensation expense of \$3 million related to the acquisition of Abaxis, for the post-merger service period. For additional details see Note 5. Acquisitions and Divestitures.

For the three and nine months ended September 30, 2018, and the three months ended October 1, 2017, amounts capitalized to inventory were insignificant. For the nine months ended October 1, 2017, we capitalized \$1 million of share-based compensation expense to inventory.

During the nine months ended September 30, 2018, the company granted 538,820 stock options with a weighted-average exercise price of \$73.32 per stock option and a weighted-average fair value of \$20.30 per stock 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 weighted-average fair value was estimated based on the following assumptions: risk-free interest rate of 2.74%; expected dividend yield of 0.69%; expected stock price volatility of 23.61%; and expected term of 6.5 years. In general, stock options vest after three years of continuous service and 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 30, 2018, the company granted 433,628 RSUs, with a weighted-average grant date fair value of \$73.37 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 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 30, 2018, the company granted 109,574 PSUs with a weighted-average grant date fair value of \$100.34 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 the S&P 500 companies, which were 21.9% and 25.1%, 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 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.

14. Stockholders' Equity

Zoetis is authorized to issue 6 billion shares of common stock and 1 billion shares of preferred stock.

In December 2016, the company's Board of Directors authorized a \$1.5 billion share repurchase program. Purchases of Zoetis shares may be made at the discretion of management, depending on market conditions and business needs. As of September 30, 2018, there was approximately \$451 million remaining under this authorization.

Changes in common shares and treasury stock were as follows:

| (MILLIONS) | Common Shares Issued ^(a) | Treasury Stock ^(a) |
|----------------------------|-------------------------------------|-------------------------------|
| Balance, December 31, 2016 | 501.89 | 9.04 |

| | | | |
|---|--------|-------|---|
| Share-based compensation ^(b) | — | (1.42 |) |
| Share repurchase program | — | 6.45 | |
| Balance, October 1, 2017 | 501.89 | 14.06 | |
| Balance, December 31, 2017 | 501.89 | 15.76 | |
| Share-based compensation ^(b) | — | (1.42 |) |
| Share repurchase program | — | 6.57 | |
| Balance, September 30, 2018 | 501.89 | 20.91 | |

^(a) Shares may not add due to rounding.

Includes the reissuance of shares from treasury stock in connection with the vesting of employee share-based

^(b) awards, and the reacquisition of shares associated with the vesting of employee share-based awards to satisfy tax withholding requirements. For additional information regarding share-based compensation, see Note 13.

Share-Based Payments.

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Changes, net of tax, in accumulated other comprehensive loss, excluding noncontrolling interests, are as follows:

| | Derivatives | Currency Translation Adjustment | Benefit Plans Actuarial | Accumulated Other Comprehensive Loss |
|---|-------------------------------------|---------------------------------------|-------------------------------|---|
| (MILLIONS OF DOLLARS) | Net Unrealized Gains/(Losses) | Net Unrealized Gains/(Losses) | Gains/(Losses) | Loss |
| Balance, December 31, 2016 | \$ 8 | \$ (583) | \$ (23) | \$ (598) |
| Other comprehensive (loss)/income, net of tax | (11) | 153 | 1 | 143 |
| Balance, October 1, 2017 | \$ (3) | \$ (430) | \$ (22) | \$ (455) |
| Balance, December 31, 2017 | \$ (3) | \$ (487) | \$ (15) | \$ (505) |
| Other comprehensive loss, net of tax | (1) | (113) | — | (114) |
| Balance, September 30, 2018 | \$ (4) | \$ (600) | \$ (15) | \$ (619) |

15. Earnings per Share

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------------|-----------------------|--------------------------|-----------------------|
| (MILLIONS OF DOLLARS AND SHARES, EXCEPT PER SHARE DATA) | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| Numerator | | | | |
| Net income before allocation to noncontrolling interests | \$347 | \$296 | \$1,079 | \$782 |
| Less: Net loss attributable to noncontrolling interests | — | (2) | (4) | (1) |
| Net income attributable to Zoetis Inc. | \$347 | \$298 | \$1,083 | \$783 |
| Denominator | | | | |
| Weighted-average common shares outstanding | 482.0 | 489.1 | 483.9 | 490.8 |
| Common stock equivalents: stock options, RSUs, PSUs and DSUs | 3.8 | 3.3 | 3.8 | 3.1 |
| Weighted-average common and potential dilutive shares outstanding | 485.8 | 492.4 | 487.7 | 493.9 |
| Earnings per share attributable to Zoetis Inc. stockholders—basic | \$0.72 | \$0.61 | \$2.24 | \$1.60 |
| Earnings per share attributable to Zoetis Inc. stockholders—diluted | \$0.71 | \$0.61 | \$2.22 | \$1.59 |

The number of stock options outstanding under the company's Equity Plan that were excluded from the computation of diluted earnings per share, as the effect would have been antidilutive, were de minimis for the three months ended September 30, 2018 and the three months ended October 1, 2017, and approximately 1 million for both the nine months ended September 30, 2018 and October 1, 2017.

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

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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 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 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 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.

Ulianopolis, Brazil

In February 2012, the Municipality of Ulianopolis (State of Para, Brazil) filed a complaint against Fort Dodge Saúde Animal Ltda. (FDSAL), a Zoetis entity, 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. On August 19, 2016, the parties and the prosecutor agreed to engage the services of a third-party consultant to conduct a limited environmental assessment of the site. The site assessment was conducted during June 2017, and a written report summarizing the results of the assessment was provided to the parties and the prosecutor in November 2017. The report noted that waste is still present on the site and that further environmental assessments are needed before a plan to manage that remaining waste can be prepared. We have not received any further communication from the prosecutor in response to the report.

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 lascadoil made its way into the animal feed, the allegations are that lascadoil 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 lascadoil 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 lascadoil, since lascadoil contains small amounts of lasalocid, the active ingredient found in both products. Zoetis has historically sold any and all industrial lascadoil byproduct to an environmental company specializing in waste disposal. The environmental company is contractually obligated to incinerate the lascadoil or resell it for use in biofuel. Under the terms of the agreement, the environmental company is expressly prohibited from reselling the lascadoil 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.

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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 in the Seventeenth Circuit Court for the State of Michigan against Shur-Green Farms alleging negligence and breach of warranty claims arising from their purchase of soy oil allegedly contaminated with lascadoil. 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 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 raises only one count against Zoetis for negligence. We filed an answer to the complaint on November 2, 2015, denying the allegation. On May 16, 2016, two additional turkey producers filed a complaint in the Seventeenth Circuit Court for the State of Michigan against the company, Restaurant Recycling, Superior, Shur-Green Farms and others, alleging claims for negligence and breach of warranties. We filed an answer to the complaint on June 20, 2016, denying the allegations. The Court has consolidated all three cases in Michigan for purposes of discovery and disposition. On July 28, 2017, we filed a motion for summary disposition on the grounds that no genuine issues of material fact exist and that Zoetis is entitled to judgment as a matter of law. On October 19, 2017, the Court granted our motion and dismissed all claims against Zoetis. On October 31, 2017, the plaintiffs filed motions for reconsideration of the Court's decision granting summary disposition. The Court, denied all such motions on December 6, 2017, for the same reasons cited in the Court's original decision. On December 27, 2017, the plaintiffs filed a request with the Michigan Court of Appeals seeking an appeal of the lower Court's decision, which we opposed on January 17, 2018. On July 5, 2018, the Court of Appeals denied the plaintiffs' applications for leave to appeal. The case has been remanded to the lower Court, where it will proceed without Zoetis. The plaintiffs may attempt to seek a full appeal after the final adjudication of the case before the lower Court.

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 companies is AlphaPharma LLC, a legal entity that was transferred to Zoetis as part of the separation from Pfizer. AlphaPharma LLC's involvement is solely related to certain discontinued human health activities that occurred prior to Pfizer's acquisition of King/AlphaPharma. As a result of the decision, a fine in the amount of euro 11 million (approximately \$14 million) was imposed on AlphaPharma. Under the Global Separation Agreement between Pfizer and Zoetis, Pfizer is obligated to indemnify Zoetis for any liabilities arising out of claims not related to its animal health assets, meaning that Pfizer ultimately bears the costs of the penalties in connection with the Commission's decision. Working with Pfizer, we filed an appeal of the decision on September 6, 2013, to the General Court of the European Union, and on September 17, 2013, Pfizer released payment of euro 11 million to the Commission to cover the fine. On September 8, 2016, the General Court upheld the decision of the European Commission. On November 25, 2016, we filed an appeal to the Court of Justice of the European Union and are awaiting a ruling.

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 30, 2018, recorded amounts for the estimated fair value of these indemnifications were not significant.

17. Segment Information**Operating Segments**

We manage our operations through two geographic operating segments: the United States and International. 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, animal health diagnostics and other pharmaceuticals, for both livestock and companion animal customers. Our chief operating decision maker uses the revenue and earnings of the two operating segments, among other factors, for performance evaluation and resource allocation.

In the first quarter of 2018, the company realigned certain management responsibilities. These changes did not impact the determination of our operating segments, however they resulted in the reallocation of certain costs between segments. These changes primarily include the following: (i) R&D costs related to our aquaculture business which were previously reported in Other business activities are now reported in the international commercial segment results, and (ii) certain other miscellaneous costs which were previously reported in Corporate are now reported in the international commercial segment results.

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, our human health diagnostics business and 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 our aquaculture business and non-U.S. market and regulatory activities are generally included in the international commercial segment.

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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, certain procurement 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 associated with acquiring and integrating newly acquired businesses, such as transaction costs and integration costs; and (iii) Certain significant items, which comprise 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 as certain 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 asset impairment charges, certain legal and commercial settlements and the impact of divestiture-related gains and losses.

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) certain 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.

Selected Statement of Income Information

| | Earnings | | Depreciation and Amortization ^(a) | |
|---------------------------|--------------------|--------------------|--|--------------------|
| | | | Three Months Ended | |
| | Three Months Ended | Three Months Ended | Three Months Ended | Three Months Ended |
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| U.S. | | | | |
| Revenue | \$757 | \$680 | | |
| Cost of sales | 151 | 141 | | |
| Gross profit | 606 | 539 | | |
| Gross margin | 80.1 % | 79.3 % | | |
| Operating expenses | 116 | 103 | | |
| Other (income)/deductions | — | — | | |
| U.S. Earnings | 490 | 436 | \$ 9 | \$ 7 |
| International | | | | |
| Revenue ^(b) | 709 | 654 | | |
| Cost of sales | 226 | 213 | | |
| Gross profit | 483 | 441 | | |
| Gross margin | 68.1 % | 67.4 % | | |
| Operating expenses | 131 | 132 | | |
| Other (income)/deductions | (1) | — | | |
| International Earnings | 353 | 309 | 11 | 10 |
| Total operating segments | 843 | 745 | 20 | 17 |

| | | | | |
|--|--------|--------|-------|-------|
| Other business activities | (84) | (77) | 6 | 5 |
| Reconciling Items: | | | | |
| Corporate | (178) | (143) | 15 | 13 |
| Purchase accounting adjustments | (49) | (23) | 43 | 22 |
| Acquisition-related costs | (40) | (6) | — | — |
| Certain significant items ^(c) | 8 | (7) | — | (1) |
| Other unallocated | (82) | (76) | — | 2 |
| Total Earnings ^(d) | \$418 | \$413 | \$ 84 | \$ 58 |

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| (MILLIONS OF DOLLARS) | Earnings | | Depreciation and Amortization ^(a) | |
|--|--------------------|-----------------|--|-----------------|
| | Nine months ended | | Nine months ended | |
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| U.S. | | | | |
| Revenue | \$2,068 | \$1,908 | | |
| Cost of sales | 431 | 412 | | |
| Gross profit | 1,637 | 1,496 | | |
| Gross margin | 79.2 % | 78.4 % | | |
| Operating expenses | 328 | 312 | | |
| Other (income)/deductions | — | — | | |
| U.S. Earnings | 1,309 | 1,184 | \$ 25 | \$ 21 |
| International | | | | |
| Revenue ^(b) | 2,163 | 1,903 | | |
| Cost of sales | 689 | 645 | | |
| Gross profit | 1,474 | 1,258 | | |
| Gross margin | 68.1 % | 66.1 % | | |
| Operating expenses | 411 | 372 | | |
| Other (income)/deductions | 2 | (1) | | |
| International Earnings | 1,061 | 887 | 34 | 32 |
| Total operating segments | 2,370 | 2,071 | 59 | 53 |
| Other business activities | (247) | (224) | 17 | 17 |
| Reconciling Items: | | | | |
| Corporate | (470) | (437) | 42 | 38 |
| Purchase accounting adjustments | (95) | (66) | 88 | 65 |
| Acquisition-related costs | (41) | (8) | — | — |
| Certain significant items ^(c) | (2) | (10) | — | 1 |
| Other unallocated | (243) | (231) | 1 | 5 |
| Total Earnings ^(d) | \$1,272 | \$1,095 | \$ 207 | \$ 179 |

^(a) 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 \$180 million and \$555 million for the three and nine months ended

^(b) September 30, 2018, respectively, and \$169 million and \$472 million for the three and nine months ended October 1, 2017, respectively.

For the three months ended September 30, 2018, primarily represents (i) employee termination costs of \$8 million,

^(c) and (ii) a net gain of \$18 million related to the relocation of a manufacturing site in China and (iii) a loss of \$2 million related to sales of certain manufacturing sites and products as a result of our supply network strategy.

For the three months ended October 1, 2017, primarily represents (i) employee termination costs of \$3 million, a reversal of exit costs of \$1 million and consulting fees of \$2 million, (ii) a net loss of \$4 million related to sales of certain manufacturing sites and products, including the anticipated disposal of our manufacturing site in Guarulhos, Brazil, related to our operational efficiency initiative and supply network strategy, and (iii) an adjustment of \$1

million related to the requirement to cease depreciation of assets, located at our manufacturing site in Guarulhos Brazil, that were classified as held for sale.

For the nine months ended September 30, 2018, primarily represents (i) consulting fees and product transfer costs of \$4 million, employee termination costs of \$1 million and exit costs of \$1 million, related to our operational efficiency initiative and supply network strategy, (ii) employee termination costs of \$11 million in Europe as a result of initiatives to better align our organizational structure, and (iii) a net gain of \$18 million related to the relocation of a manufacturing site in China, and (iv) a loss of \$2 million related to sales of certain manufacturing sites and products related to our supply network strategy.

For the nine months ended October 1, 2017, primarily includes: (i) a reversal of previously accrued employee termination costs of \$1 million, accelerated depreciation of \$2 million and consulting fees of \$5 million, related to our operational efficiency initiative and supply network strategy; (ii) a net loss of \$6 million related to sales of certain manufacturing sites and products, including the anticipated disposal of our manufacturing site in Guarulhos, Brazil, related to our operational efficiency initiative and supply network strategy; (iii) charges of \$3 million associated with changes to our operating model; (iv) income of \$4 million related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016; and (v) an adjustment of \$1 million related to the requirement to cease depreciation of assets, located at our manufacturing site in Guarulhos Brazil, that are currently classified as held for sale.

^(d) Defined as income before provision for taxes on income.

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18. Subsequent Events

In September 2018, we received total cash proceeds of approximately \$44 million related to the divestiture of certain agribusiness products within our international segment. During the fourth quarter of 2018, we recorded a net pre-tax gain of approximately \$40 million within Other (income)/deductions— net, related to this divestiture.

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Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors

Zoetis Inc.:

Results of Review of Interim Financial Information

We have reviewed the condensed consolidated balance sheet of Zoetis Inc. and subsidiaries (the Company) as of September 30, 2018, the related condensed consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2018 and October 1, 2017, the related condensed consolidated statements of equity and cash flows for the nine-month periods ended September 30, 2018 and October 1, 2017, and the related notes (collectively, the consolidated interim financial information). Based on our reviews, we are not aware of any material modifications that should be made to the consolidated interim financial information for it to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Company as of December 31, 2017, 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 15, 2018, 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, 2017, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

This consolidated interim financial information is the responsibility of the Company's management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our reviews in accordance with the standards of the PCAOB. A review of consolidated 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 PCAOB, 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.

/s/ KPMG LLP

Short Hills, New Jersey

November 1, 2018

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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 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: the United States (U.S.) and International. 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. See Notes to Condensed Consolidated Financial Statements — Note 17. Segment Information.

We directly market our products to veterinarians and livestock producers located in approximately 45 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 Mexico, we believe we are one of the largest animal health medicines and vaccines businesses 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 one of the industry's largest sales organizations, 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, have 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 2018 performance compared with the comparable 2017 period follows:

| (MILLIONS OF DOLLARS) | Three Months Ended | | % Change | | |
|------------------------------------|--------------------|-----------------|----------|---------------------|------------------------------------|
| | September 30, 2018 | October 1, 2017 | Total | Related to Exchange | Foreign Operational ^(a) |
| | Revenue | \$1,480 | \$1,347 | 10 | (2) |
| Net income attributable to Zoetis | 347 | 298 | 16 | (10) | 26 |
| Adjusted net income ^(a) | 403 | 322 | 25 | (7) | 32 |

| (MILLIONS OF DOLLARS) | Nine Months Ended | | % Change | | |
|------------------------------------|--------------------|-----------------|----------|---------------------|------------------------------------|
| | September 30, 2018 | October 1, 2017 | Total | Related to Exchange | Foreign Operational ^(a) |
| | Revenue | \$4,261 | \$3,847 | 11 | 2 |
| Net income attributable to Zoetis | 1,083 | 783 | 38 | 1 | 37 |
| Adjusted net income ^(a) | 1,143 | 844 | 35 | 1 | 34 |

^(a) Operational growth and adjusted net income are non-GAAP financial measures. See the Non-GAAP financial measures section of this Management's Discussion and Analysis (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 2017 Annual Report on Form 10-K. Set forth below are updates to certain of the factors disclosed in our 2017 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. At the same time, sales of products that treat specific disease outbreaks may increase.

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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 100 countries and, as a result, our revenue is influenced by changes in foreign exchange rates. For the nine months ended September 30, 2018, approximately 49% 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 Australian dollar, Brazilian real, Canadian dollar, Chinese yuan, euro, U.K. pound 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 30, 2018, approximately 51% of our total revenue was in U.S. dollars. Our year-over-year revenue growth was favorably impacted by approximately 2% from changes in foreign currency values relative to the U.S. dollar.

Non-GAAP financial measures

We report information in accordance with U.S. generally accepted accounting principles (GAAP). Management also measures performance using non-GAAP financial measures that may exclude certain amounts from the most directly comparable GAAP measure. Despite the importance of these measures to management in goal setting and performance measurement, non-GAAP financial measures have no standardized meaning prescribed by U.S. GAAP and, therefore, have limits in their usefulness to investors and may not be comparable to the calculation of similar measures of other companies. We present certain identified non-GAAP measures solely to provide investors with useful information to more fully understand how management assesses performance.

Operational Growth

We believe that it is important to not only understand overall revenue and earnings growth, but also “operational growth.” Operational growth is a non-GAAP financial measure defined as revenue or earnings growth excluding the impact of foreign exchange. This measure provides information on the change in revenue and earnings as if foreign currency exchange rates had not changed between the current and prior periods to facilitate a period-to-period comparison. We believe this non-GAAP measure provides a useful comparison to previous periods for the company and investors, but should not be viewed as a substitute for U.S. GAAP reported growth.

Adjusted Net Income and Adjusted Earnings Per Share

Adjusted net income and the corresponding adjusted earnings per share (EPS) are non-GAAP financial measures of performance used by management. We believe these financial measures are useful supplemental information to investors when considered together with our U.S. GAAP financial measures. We report adjusted net income to portray the results of our major operations, and the discovery, development, manufacture and commercialization of our products, prior to considering certain income statement elements. We define adjusted net income and adjusted EPS as net income attributable to Zoetis and EPS before the impact of purchase accounting adjustments, acquisition-related costs and certain significant items.

We recognize that, as an internal measure of performance, the adjusted net income and adjusted EPS measures have limitations, and we do not restrict our performance management process solely to these metrics. A limitation of the adjusted net income and adjusted EPS measures is that they provide 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 do not provide a comparable view of our performance to other companies. The adjusted net income and adjusted EPS measures are not, and should not be viewed as, a substitute for U.S. GAAP reported net income attributable to Zoetis and reported EPS. See the Adjusted Net Income section below for more information.

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 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| Revenue | \$1,480 | \$1,347 | 10 | \$4,261 | \$3,847 | 11 |
| Costs and expenses: | | | | | | |
| Cost of sales ^(a) | 473 | 435 | 9 | 1,367 | 1,318 | 4 |
| % of revenue | 32.0 | % 32.3 | % | 32.1 | % 34.3 | % |
| Selling, general and administrative expenses ^(a) | 367 | 328 | 12 | 1,064 | 973 | 9 |
| % of revenue | 25 | % 24 | % | 25 | % 25 | % |
| Research and development expenses ^(a) | 108 | 96 | 13 | 307 | 272 | 13 |
| % of revenue | 7 | % 7 | % | 7 | % 7 | % |
| Amortization of intangible assets ^(a) | 32 | 23 | 39 | 78 | 68 | 15 |
| Restructuring charges/(reversals) and certain acquisition-related costs | 47 | 8 | * | 54 | 7 | * |
| Interest expense, net of capitalized interest | 54 | 43 | 26 | 147 | 125 | 18 |
| Other (income)/deductions—net | (19) |) 1 | * | (28) |) (11) | * |
| Income before provision for taxes on income | 418 | 413 | 1 | 1,272 | 1,095 | 16 |
| % of revenue | 28 | % 31 | % | 30 | % 28 | % |
| Provision for taxes on income | 71 | 117 | (39) |) 193 | 313 | (38) |
| Effective tax rate | 17.0 | % 28.3 | % | 15.2 | % 28.6 | % |
| Net income before allocation to noncontrolling interests | 347 | 296 | 17 | 1,079 | 782 | 38 |
| Less: Net (loss)/income attributable to noncontrolling interests | — | (2) |) (100) |) (4) |) (1) |) * |
| Net income attributable to Zoetis | \$347 | \$298 | 16 | \$1,083 | \$783 | 38 |
| % of revenue | 23 | % 22 | % | 25 | % 20 | % |

* 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

^(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.

Revenue

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Total revenue increased by \$133 million, or 10%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, an increase of \$160 million, or 12%, on an operational basis. Operational revenue growth was comprised primarily of the following:

• price growth of approximately 4%;

• increased volume from our key dermatology products of approximately 3%;

• the acquisition of Abaxis which contributed approximately 3%; and

• volume growth from new products of approximately 2%.

Foreign exchange decreased reported revenue growth by approximately 2%.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Total revenue increased by \$414 million, or 11%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, an increase of \$363 million, or 9%, on an operational basis. Operational revenue growth was comprised primarily of the following:

- increased volume from in-line products of approximately 4%, including 3% from our key dermatology products;
- price growth of approximately 2%;
- volume growth from new products of approximately 2%; and

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the acquisition of Abaxis which contributed approximately 1%.

Foreign exchange increased reported revenue growth by approximately 2%.

Costs and Expenses

Cost of sales

| | Three Months Ended | | | Nine Months Ended | | |
|-----------------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Cost of sales | \$473 | \$435 | 9 | \$1,367 | \$1,318 | 4 |
| % of revenue | 32.0 % | 32.3 % | | 32.1 % | 34.3 % | |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Cost of sales as a percentage of revenue decreased from 32.3% to 32.0% in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily as a result of:

continued cost improvements and efficiencies in our manufacturing network,

partially offset by:

unfavorable foreign exchange; and

- the inclusion of Abaxis.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Cost of sales as a percentage of revenue decreased from 34.3% to 32.1% in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily as a result of:

continued cost improvements and efficiencies in our manufacturing network; and

favorable foreign exchange,

partially offset by:

- the inclusion of Abaxis.

Selling, general and administrative expenses

| | Three Months Ended | | | Nine Months Ended | | |
|--|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Selling, general and administrative expenses | \$367 | \$ 328 | 12 | \$1,064 | \$973 | 9 |
| % of revenue | 25 % | 24 % | | 25 % | 25 % | |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Selling, general & administrative (SG&A) expenses increased by \$39 million, or 12%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily as a result of:

- the inclusion of Abaxis;

an increase in certain compensation-related expenses; and

higher professional services and consulting charges,

partially offset by:

favorable foreign exchange.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Selling, general & administrative (SG&A) expenses increased by \$91 million, or 9%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily as a result of:

- an increase in certain compensation-related expenses;
- the inclusion of
 - Abaxis;
- higher professional services and consulting charges; and

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unfavorable foreign exchange.

Research and development expenses

| | Three Months Ended | | | Nine Months Ended | | |
|-----------------------------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Research and development expenses | \$108 | \$96 | 13 | \$307 | \$272 | 13 |
| % of revenue | 7 | % 7 | % | 7 | % 7 | % |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

R&D expenses increased by \$12 million, or 13%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily as a result of:

- increased headcount and other spending driven by project investments; and
- the inclusion of
 - Abaxis.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

R&D expenses increased by \$35 million, or 13%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily as a result of:

- increased headcount driven by project investments;
- the inclusion of
 - Abaxis;
- unfavorable foreign exchange; and
- an increase in certain compensation-related expenses.

Amortization of intangible assets

| | Three Months Ended | | | Nine Months Ended | | |
|-----------------------------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Amortization of intangible assets | \$32 | \$23 | 39 | \$78 | \$68 | 15 |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Amortization of intangible assets increased by \$9 million, or 39%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, as a result of certain intangible assets acquired in July 2018 as part of the acquisition of Abaxis.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Amortization of intangible assets increased by \$10 million, or 15%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017 as a result of certain intangible assets acquired in July 2018 as part of the acquisition of Abaxis.

Restructuring charges/(reversals) and certain acquisition-related costs

| | Three Months Ended | | | Nine Months Ended | | |
|---|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Restructuring charges/(reversals) and certain acquisition-related costs | \$47 | \$8 | * | \$54 | \$7 | * |

Certain amounts and percentages may reflect rounding adjustments.

During 2015, we launched a comprehensive operational efficiency program, which was incremental to the previously announced supply network strategy. These initiatives focused on reducing complexity in our product portfolios, changing our selling approach in certain markets, reducing our presence in certain countries, and exiting manufacturing sites over a long term period. We have also continued to optimize our resource allocation and efficiency by reducing resources associated with non-customer facing activities and operating more efficiently as a result of less internal complexity and more standardization of processes. The comprehensive operational efficiency program was substantially completed as of December 31, 2017. We expect to complete the supply network strategy over the next several years.

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Our acquisition-related costs primarily relate 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 also exited a number of distributor and other contracts and performed certain 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 30, 2018 vs. three months ended October 1, 2017

The change in restructuring charges and certain acquisition-related costs from \$8 million in the three months ended October 1, 2017, to \$47 million in the three months ended September 30, 2018, is due to charges in the three months ended September 30, 2018, related to transaction costs, integration costs and employee termination costs as a result of the acquisition of Abaxis in the third quarter of 2018, and employee termination costs in Europe as a result of initiatives to better align our organizational structure.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

The change in restructuring charges and certain acquisition-related costs from a \$7 million reversal in the nine months ended October 1, 2017, to \$54 million in the nine months ended September 30, 2018, is primarily due to charges in the nine months ended September 30, 2018, related to transaction costs, integration costs and employee termination costs as a result of the acquisition of Abaxis in the third quarter of 2018, employee termination costs in Europe as a result of initiatives to better align our organizational structure, and employee termination costs and exit costs as a result of our operational efficiency initiative and supply network strategy.

Interest expense, net of capitalized interest

| | Three Months Ended | | | Nine Months Ended | | |
|---|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Interest expense, net of capitalized interest | \$ 54 | \$ 43 | 26 | \$ 147 | \$ 125 | 18 |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Interest expense, net of capitalized interest, increased by \$11 million, or 26% in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, as a result of the issuance of \$1.5 billion aggregate principal amount of our senior notes in August 2018.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Interest expense, net of capitalized interest, increased by \$22 million, or 18% in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, as a result of the issuance of \$1.5 billion aggregate principal amount of our senior notes in August 2018.

Other (income)/deductions—net

| | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Other (income)/deductions—net | \$ (19) | \$ 1 | * | \$ (28) | \$ (11) | * |

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

The change in Other (income)/deductions—net from deductions of \$1 million in the three months ended October 1, 2017, to income of \$19 million in the three months ended September 30, 2018, is primarily a result of:

a net gain of \$18 million in the three months ended September 30, 2018 related to the relocation of a manufacturing site in China; and

- higher interest income in the three months ended September 30, 2018 due to higher cash balances, partially offset by:
- a loss of \$2 million three months ended September 30, 2018 related to divestitures as part of our supply network strategy; and
- higher foreign currency losses in the three months ended September 30, 2018 primarily driven by costs related to hedging and exposures to certain emerging market currencies.

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Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

The change in Other (income)/deductions—net from income of \$11 million in the nine months ended October 1, 2017, to income of \$28 million in the nine months ended September 30, 2018, is primarily a result of:

- a net gain of \$18 million in the nine months ended September 30, 2018 related to the relocation of a manufacturing site in China; and
- higher interest income in the nine months ended September 30, 2018 due to higher cash balances, partially offset by:
 - higher foreign currency losses in the nine months ended September 30, 2018 primarily driven by costs related to hedging and exposures to certain emerging market currencies;
 - a loss of \$2 million in the nine months ended September 30, 2018 related to divestitures as part of our supply network strategy; and
 - income of \$4 million in the nine months ended October 1, 2017 related to an insurance recovery from commercial settlements in Mexico recorded in 2014 and 2016.

Provision for taxes on income

| | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------|--------------------|-----------------|----------|--------------------|-----------------|----------|
| | September 30, 2018 | October 1, 2017 | % Change | September 30, 2018 | October 1, 2017 | % Change |
| (MILLIONS OF DOLLARS) | | | | | | |
| Provision for taxes on income | \$71 | \$117 | (39) | \$193 | \$313 | (38) |
| Effective tax rate | 17.0% | 28.3 % | | 15.2 % | 28.6 % | |

Certain amounts and percentages may reflect rounding adjustments.

On December 22, 2017, the Tax Cuts and Jobs Act (the Tax Act) was enacted which, among other changes, reduced the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018. The Tax Act made broad and complex changes to the U.S. tax code and it will take time to fully analyze the impact of the changes. Based on the information available at that time, and the current interpretation of the Tax Act, for the year ended December 31, 2017 the company was able to make a reasonable estimate and recorded an initial provisional net tax expense of \$212 million related to the one-time mandatory deemed repatriation tax, payable over eight years, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. Pursuant to the Staff Accounting Bulletin published by the Securities and Exchange Commission on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date (measurement-period adjustment). Pursuant to this guidance, the estimated impact of the Tax Act was based on a preliminary review of the new tax law and projected future financial results and is subject to revision based upon further analysis and interpretation of the Tax Act and to the extent that future results differ from currently available projections.

In 2018, we were able to further refine our initial reasonable estimate and adjusted the initial provisional net tax expense of \$212 million. On the basis of revised computations that were calculated during the reporting period, we recognized a measurement-period adjustment of \$23 million and \$58 million for the three and nine months ended September 30, 2018, respectively, as a decrease to the one-time mandatory deemed repatriation tax obligation, with a corresponding adjustment to income tax benefit during the period.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

The effective tax rate was 17.0% for the three months ended September 30, 2018, compared with 28.3% for the three months ended October 1, 2017. The lower effective tax rate for the three months ended September 30, 2018, was primarily attributable to:

- the reduction of the U.S. federal corporate income tax rate, from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;

a \$23 million net tax benefit recorded in the third quarter of 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;

changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items; and

a \$3 million and \$1 million discrete tax benefit recorded in the third quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

The effective tax rate was 15.2% for the nine months ended September 30, 2018, compared with 28.6% for the nine months ended October 1, 2017. The lower effective tax rate for the nine months ended September 30, 2018, was primarily attributable to:

the reduction of the U.S. federal corporate income tax rate, from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act;

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a \$58 million net tax benefit recorded in the nine months ended 2018, associated with a measurement-period adjustment related to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings pursuant to the Tax Act enacted on December 22, 2017;

changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings from operations and repatriation costs. The jurisdictional mix of earnings can vary as a result of repatriation decisions and operating fluctuations in the normal course of business and the impact of non-deductible items;

a \$12 million and \$8 million discrete tax benefit recorded in the nine months ended 2018 and 2017, respectively, related to the excess tax benefits for share-based payments; and

an \$8 million and \$3 million discrete tax benefit recorded in the nine months ended 2018 and 2017, respectively, related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

Operating Segment Results

In the first quarter of 2018, the company realigned certain management responsibilities. These changes did not impact the determination of our operating segments, however they resulted in the reallocation of certain costs between segments. These changes primarily include the following: i) R&D costs related to our aquaculture business which were previously reported in Other business activities are now reported in the international commercial segment results, and ii) certain other miscellaneous costs which were previously reported in Corporate are now reported in the international commercial segment results.

On a global basis, the mix of revenue between livestock and companion animal products was as follows:

| (MILLIONS OF DOLLARS) | % Change | | | | | |
|---|--------------------|-----------------|-------|------------|------|-------------|
| | Three Months Ended | | Total | Related to | | |
| | September 30, 2018 | October 1, 2017 | | Foreign | | Operational |
| U.S. | | | | | | |
| Livestock | \$322 | \$319 | 1 | % — | % 1 | % |
| Companion animal | 435 | 361 | 20 | % — | % 20 | % |
| | 757 | 680 | 11 | % — | % 11 | % |
| International | | | | | | |
| Livestock | 456 | 435 | 5 | % (5) | % 10 | % |
| Companion animal | 253 | 219 | 16 | % (2) | % 18 | % |
| | 709 | 654 | 8 | % (4) | % 12 | % |
| Total | | | | | | |
| Livestock | 778 | 754 | 3 | % (3) | % 6 | % |
| Companion animal | 688 | 580 | 19 | % — | % 19 | % |
| Contract manufacturing & human health diagnostics | 14 | 13 | 8 | % (3) | % 11 | % |
| | \$1,480 | \$1,347 | 10 | % (2) | % 12 | % |

Certain amounts and percentages may reflect rounding adjustments.

| (MILLIONS OF DOLLARS) | % Change | | | | | |
|---|--------------------|-----------------|-------|------------|--------|-------------|
| | Nine Months Ended | | Total | Related to | | |
| | September 30, 2018 | October 1, 2017 | | Foreign | | Operational |
| U.S. | | | | | | |
| Livestock | \$885 | \$870 | 2 | % — | % 2 | % |
| Companion animal | 1,183 | 1,038 | 14 | % — | % 14 | % |
| | 2,068 | 1,908 | 8 | % — | % 8 | % |
| International | | | | | | |
| Livestock | 1,397 | 1,276 | 9 | % 1 | % 8 | % |
| Companion animal | 766 | 627 | 22 | % 4 | % 18 | % |
| | 2,163 | 1,903 | 14 | % 3 | % 11 | % |
| Total | | | | | | |
| Livestock | 2,282 | 2,146 | 6 | % 1 | % 5 | % |
| Companion animal | 1,949 | 1,665 | 17 | % 2 | % 15 | % |
| Contract manufacturing & human health diagnostics | 30 | 36 | (17) | % 1 | % (18) | % |
| | \$4,261 | \$3,847 | 11 | % 2 | % 9 | % |

Certain amounts and percentages may reflect rounding adjustments.

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

| (MILLIONS OF DOLLARS) | Three Months Ended | | % Change | | |
|---|--------------------|-----------------|----------|-----------------------------|-------------|
| | September 30, 2018 | October 1, 2017 | Total | Related to Foreign Exchange | Operational |
| U.S. | | | | | |
| Revenue | \$757 | \$680 | 11 | — | 11 |
| Cost of Sales | 151 | 141 | 7 | — | 7 |
| Gross Profit | 606 | 539 | 12 | — | 12 |
| Gross Margin | 80.1 % | 79.3 % | | | |
| Operating Expenses | 116 | 103 | 13 | — | 13 |
| Other (income)/deductions | — | — | — | — | — |
| U.S. Earnings | 490 | 436 | 12 | — | 12 |
| International | | | | | |
| Revenue | 709 | 654 | 8 | (4) | 12 |
| Cost of Sales | 226 | 213 | 6 | (3) | 9 |
| Gross Profit | 483 | 441 | 10 | (4) | 14 |
| Gross Margin | 68.1 % | 67.4 % | | | |
| Operating Expenses | 131 | 132 | (1) | (4) | 3 |
| Other (income)/deductions | (1) | — | * | * | * |
| International Earnings | 353 | 309 | 14 | (5) | 19 |
| Total operating segments | 843 | 745 | 13 | (2) | 15 |
| Other business activities | (84) | (77) | 9 | | |
| Reconciling Items: | | | | | |
| Corporate | (178) | (143) | 24 | | |
| Purchase accounting adjustments | (49) | (23) | * | | |
| Acquisition-related costs | (40) | (6) | * | | |
| Certain significant items | 8 | (7) | * | | |
| Other unallocated | (82) | (76) | 8 | | |
| Income before provision for taxes on income | \$418 | \$413 | 1 | | |

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

| (MILLIONS OF DOLLARS) | Nine Months Ended | | % Change | | |
|---|--------------------|-----------------|----------|-----------------------------|-------------|
| | September 30, 2018 | October 1, 2017 | Total | Related to Foreign Exchange | Operational |
| U.S. | | | | | |
| Revenue | \$2,068 | \$1,908 | 8 | — | 8 |
| Cost of Sales | 431 | 412 | 5 | — | 5 |
| Gross Profit | 1,637 | 1,496 | 9 | — | 9 |
| Gross Margin | 79.2 % | 78.4 % | | | |
| Operating Expenses | 328 | 312 | 5 | — | 5 |
| Other (income)/deductions | — | — | — | — | — |
| U.S. Earnings | 1,309 | 1,184 | 11 | — | 11 |
| International | | | | | |
| Revenue | 2,163 | 1,903 | 14 | 3 | 11 |
| Cost of Sales | 689 | 645 | 7 | 2 | 5 |
| Gross Profit | 1,474 | 1,258 | 17 | 3 | 14 |
| Gross Margin | 68.1 % | 66.1 % | | | |
| Operating Expenses | 411 | 372 | 10 | 2 | 8 |
| Other (income)/deductions | 2 | (1) | * | * | * |
| International Earnings | 1,061 | 887 | 20 | 3 | 17 |
| Total operating segments | 2,370 | 2,071 | 14 | 1 | 13 |
| Other business activities | (247) | (224) | 10 | | |
| Reconciling Items: | | | | | |
| Corporate | (470) | (437) | 8 | | |
| Purchase accounting adjustments | (95) | (66) | 44 | | |
| Acquisition-related costs | (41) | (8) | * | | |
| Certain significant items | (2) | (10) | (80) | | |
| Other unallocated | (243) | (231) | 5 | | |
| Income before provision for taxes on income | \$1,272 | \$1,095 | 16 | | |

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

U.S. operating segment

U.S. segment revenue increased by \$77 million, or 11%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, reflecting growth of approximately \$74 million in companion animal products and approximately \$3 million in livestock products.

Companion animal revenue growth was driven primarily by increased sales of the dermatology portfolio, the acquisition of Abaxis, and new products including Simparica®. Growth was tempered by lower sales of certain in-line products due to anticipated competition.

Livestock revenue increased primarily due to higher sales of poultry and swine products, offset by declines in the cattle business. For poultry, growth was driven by increased sales of alternatives to antibiotic medicated feed additive products. Swine growth was primarily due to promotional activities. Cattle sales declined due to competitor products returning to the market and unfavorable market conditions in dairy.

U.S. segment earnings increased by \$54 million, or 12%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily due to revenue growth and improved gross margins.

International operating segment

International segment revenue increased by \$55 million, or 8%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017. Operational revenue increased by \$82 million, or 12%, driven by growth of approximately \$42 million in livestock products and growth of approximately \$40 million in companion animal products.

Companion animal revenue growth resulted primarily from increased sales across multiple international markets of the dermatology portfolio, and new products including Simparica®, as well as the acquisition of Abaxis.

- Livestock growth was driven primarily by increased sales in our swine, cattle and poultry portfolios. Swine growth was primarily due to new vaccine products and timing of customer purchases in China. Cattle growth reflects the recovery of the previous quarter negative impact regarding the national trucking industry strike in Brazil.

Additionally, segment revenue was unfavorably impacted by foreign exchange, which decreased revenue by approximately \$27 million, or 4%, primarily driven by the depreciation in the Brazilian real, Argentinian peso, and Turkish lira, partially offset by the appreciation of the euro.

International segment earnings increased by \$44 million, or 14%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017. Operational earnings growth was \$59 million, or 19%, primarily due to higher revenue and improved gross margin.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

U.S. operating segment

U.S. segment revenue increased by \$160 million, or 8%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, reflecting growth of approximately \$145 million in companion animal products and growth of approximately \$15 million in livestock products.

Companion animal revenue growth was driven primarily by increased sales of the dermatology portfolio, as well as new products and the inclusion of Abaxis. Growth was tempered by lower sales of certain in-line products due to anticipated competition.

Livestock revenue increased primarily due to higher sales of poultry and swine products offset by declines in the cattle business. For poultry, growth was driven by increased sales of alternatives to antibiotic medicated feed additive products. Swine growth was primarily due to promotional activities and new product launches. The decline in cattle sales is due to unfavorable market conditions in dairy as well as competitor promotional activities.

U.S. segment earnings increased by \$125 million, or 11%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily due to revenue growth and improved gross margins.

International operating segment

International segment revenue increased by \$260 million, or 14%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017. Operational revenue increased by \$210 million, or 11%, driven by growth of approximately \$113 million in companion animal products and growth of approximately \$97 million in livestock products.

Companion animal revenue growth resulted primarily from increased sales across multiple international markets of the dermatology portfolio, and new products including Simparica®, as well as growth in vaccines in China.

Livestock growth was driven primarily by strong performance in cattle, swine and poultry products. Growth in cattle was due to anti-infective and biological products. Swine growth was primarily due to new vaccine products. Growth in poultry products was driven by increased sales of vaccines and medicated feed additives.

Additionally, segment revenue was favorably impacted by foreign exchange, which increased revenue by approximately \$50 million, or 3%, primarily driven by the appreciation of the euro, U.K. pound, Chinese renminbi, and Canadian dollar, partially offset by depreciation in the Brazilian Real.

International segment earnings increased by \$174 million, or 20%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017. Operational earnings growth was \$147 million, or 17%, primarily due to higher revenue and improved gross margin, partially offset by higher operating expenses.

Other business activities

Other business activities includes our Client Supply Services (CSS) contract manufacturing results, our human health diagnostics business and 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 segments.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Other business activities net loss increased by \$7 million, or 9%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, reflecting an increase in R&D project investments, compensation-related costs, the inclusion of Abaxis expenses, and the inclusion of the Irish biologic therapeutics business acquired in 2017, partially offset by revenue from the acquired Abaxis human health diagnostic business.

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Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Other business activities net loss increased by \$23 million, or 10%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, reflecting an increase in R&D project investments, compensation-related costs, the inclusion of Abaxis expenses, unfavorable foreign exchange, and the inclusion of the Irish biologic therapeutics business acquired in 2017, partially offset by revenue from the acquired Abaxis human health diagnostic business.

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, certain procurement 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 acquisition 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) certain procurement costs.

Three months ended September 30, 2018 vs. three months ended October 1, 2017

Corporate expenses increased by \$35 million, or 24%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily due to expenses related to the Abaxis transaction, certain compensation related costs not allocated to our operating segments, project spending and unfavorable foreign exchange.

Other unallocated expenses increased by \$6 million, or 8%, in the three months ended September 30, 2018, compared with the three months ended October 1, 2017, primarily due to the unfavorable impact of foreign exchange.

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Corporate expenses increased by \$33 million, or 8%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily due to an increase in certain compensation costs not allocated to our operating segments, expenses related to the Abaxis transaction, and project spending, partially offset by favorable foreign exchange.

Other unallocated expenses increased by \$12 million, or 5%, in the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, primarily due to the unfavorable impact of foreign exchange, partially offset by continued cost improvements and efficiencies in our manufacturing network, and lower global manufacturing and supply costs.

See Notes to Condensed Consolidated Financial Statements—Note 17. Segment 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. The adjusted net income measure is an important internal measurement for us. Additionally, 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.

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 Abaxis (acquired in July 2018), the Pharmaq business (acquired in November 2015), certain assets of Abbott Animal Health (acquired in February 2015), King Animal Health (KAH) (acquired in 2011), Fort Dodge Animal Health (FDAH) (acquired in 2009), and Pharmacia Animal Health business (acquired in 2003), 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.

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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 and integration 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 acquire 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 costs associated with a business combination may occur over several years, with the more significant impacts generally 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 represent 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; significant currency devaluation; 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.

Reconciliation

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

| | Three Months | | | Nine Months | | |
|---|--------------|---------|--------|-------------|---------|--------|
| | Ended | | % | Ended | | % |
| | September | October | | September | October | |
| (MILLIONS OF DOLLARS) | 30, | 1, | | 30, | 1, | |
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| GAAP reported net income attributable to Zoetis | \$347 | \$ 298 | 16 | \$1,083 | \$ 783 | 38 |
| Purchase accounting adjustments—net of tax | 37 | 16 | * | 68 | 50 | 36 |
| Acquisition-related costs—net of tax | 31 | 4 | * | 32 | 5 | * |
| Certain significant items—net of tax | (12) | 4 | * | (40) | 6 | * |
| Non-GAAP adjusted net income ^(a) | \$403 | \$ 322 | 25 | \$1,143 | \$ 844 | 35 |

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

The effective tax rate on adjusted pretax income is 19.2% and 28.7% for the three months ended September 30, 2018, and October 1, 2017, respectively. The lower effective tax rate for the three months ended September 30, 2018, compared with the three months ended October 1, 2017, was primarily attributable to (i) the reduction of the

^(a) U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act, (ii) changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, and (iii) a \$3 million and \$1 million discrete tax benefit recorded in the third quarter of 2018 and 2017, respectively, related to the excess tax benefits for share-based payments.

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The effective tax rate on adjusted pretax income is 19.2% and 28.5% for the nine months ended September 30, 2018, and October 1, 2017, respectively. The lower effective tax rate for the nine months ended September 30, 2018, compared with the nine months ended October 1, 2017, was primarily attributable to (i) the reduction of the U.S. federal corporate income tax rate from 35% to 21%, effective January 1, 2018, pursuant to the Tax Act, (ii) changes in the jurisdictional mix of earnings, which includes the impact of the location of earnings as well as repatriation costs, (iii) a \$12 million and \$8 million discrete tax benefit recorded in the nine months ended September 30, 2018 and October 1, 2017, respectively, related to the excess tax benefits for share-based payments, and (iv) an \$8 million and \$3 million discrete tax benefit recorded in the nine months ended September 30, 2018 and October 1, 2017, respectively, related to a remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates. A reconciliation of reported diluted earnings per share (EPS), as reported under U.S. GAAP, to non-GAAP adjusted diluted EPS follows:

| | Three Months | | | Nine Months | | |
|--|--------------------|-----------------|----|--------------------|-----------------|----|
| | Ended | | % | Ended | | % |
| | September 30, 2018 | October 1, 2017 | | September 30, 2018 | October 1, 2017 | |
| Earnings per share—diluted | | | | | | |
| GAAP reported EPS attributable to Zoetis—diluted | \$0.71 | \$0.61 | 16 | \$2.22 | \$1.59 | 40 |
| Purchase accounting adjustments—net of tax | 0.08 | 0.02 | * | 0.14 | 0.10 | 40 |
| Acquisition-related costs—net of tax | 0.06 | 0.01 | * | 0.06 | 0.01 | * |
| Certain significant items—net of tax | (0.02) | 0.01 | * | (0.08) | 0.01 | * |
| Non-GAAP adjusted EPS—diluted | \$0.83 | \$0.65 | 28 | \$2.34 | \$1.71 | 37 |

* Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Diluted earnings per share was computed using the weighted-average common shares outstanding during the (a) period plus the common stock equivalents related to stock options, restricted stock units, performance-vesting restricted stock units and deferred stock units.

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

| | Three Months | | Nine Months | |
|---|--------------------|-----------------|--------------------|-----------------|
| | Ended | | Ended | |
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Interest expense, net of capitalized interest | \$54 | \$43 | \$147 | \$125 |
| Interest income | 6 | 3 | 20 | 8 |
| Income taxes | 96 | 129 | 271 | 336 |
| Depreciation | 36 | 33 | 106 | 100 |
| Amortization | 5 | 4 | 13 | 13 |

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Purchase accounting adjustments: | | | | |
| Amortization and depreciation ^(a) | \$29 | \$ 21 | \$67 | \$ 61 |
| Cost of sales ^(b) | 9 | 2 | 13 | 5 |
| Other | 11 | — | 15 | — |
| Total purchase accounting adjustments—pre-tax | 49 | 23 | 95 | 66 |
| Income taxes ^(c) | 12 | 7 | 27 | 16 |
| Total purchase accounting adjustments—net of tax | 37 | 16 | 68 | 50 |
| Acquisition-related costs: | | | | |
| Transaction costs ^(d) | 21 | — | 21 | — |
| Integration costs ^(e) | 9 | 2 | 10 | 4 |
| Restructuring costs ^(f) | 10 | 4 | 10 | 4 |
| Total acquisition-related costs—pre-tax | 40 | 6 | 41 | 8 |
| Income taxes ^(c) | 9 | 2 | 9 | 3 |
| Total acquisition-related costs—net of tax | 31 | 4 | 32 | 5 |
| Certain significant items: | | | | |
| Operational efficiency initiative ^(g) | (1) | (1) | — | 4 |
| Supply network strategy ^(g) | 3 | 8 | 8 | 7 |
| Other restructuring charges and cost-reduction/productivity initiatives | 8 | — | 11 | — |
| Other ^(h) | (18) | — | (17) | (1) |
| Total certain significant items—pre-tax | (8) | 7 | 2 | 10 |
| Income taxes ^(c) | 4 | 3 | 42 | 4 |
| Total certain significant items—net of tax | (12) | 4 | (40) | 6 |
| Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax | \$56 | \$ 24 | \$60 | \$ 61 |

Certain amounts may reflect rounding adjustments.

(a) Amortization and depreciation expenses related to Purchase accounting adjustments with respect to identifiable intangible assets and property, plant and equipment.

(b) Amortization and depreciation expense.

(c) 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 three months ended September 30, 2018, also includes a tax benefit related to the remeasurement of deferred taxes as a result of a change in non-U.S. statutory tax rates.

Income taxes in Purchase accounting adjustments for the nine months ended October 1, 2017, also includes a tax benefit related to the remeasurement of deferred taxes as a result of a change in tax rates and a net tax charge related to prior period tax adjustments.

Income taxes in Acquisition-related costs for the three and nine months ended September 30, 2018, also includes a tax charge related to the non-deductibility of certain costs associated with the acquisition of Abaxis.

Income taxes in Certain significant items for the three and nine months ended September 30, 2018, includes a net tax benefit related to a measurement-period adjustment to the provisional one-time mandatory deemed repatriation tax on the company's undistributed non-U.S. earnings, pursuant to the Tax Act.

Income taxes in Certain significant items for the nine months ended October 1, 2017, also includes a net charge related to the remeasurement of the company's deferred tax assets and liabilities, using the rates expected to be in place at the time of the reversal.

- (d) Transaction costs represent external costs directly related to acquiring businesses and primarily include expenditures for banking, legal, accounting and other similar services.
- (e) 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.
- (f) Represents employee termination costs related to the acquisition of Abaxis in the third quarter of 2018 and the acquisition of an Irish biologic therapeutics company in the third quarter of 2017.
- (g) Represents employee termination costs, exit costs, consulting fees, product transfer costs and net (gains)/losses on sales of certain manufacturing sites and products related to cost-reduction and productivity initiatives.
- (h) For the three and nine months ended September 30, 2018, primarily represents a net gain related to the relocation of a manufacturing site in China.

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The classification of the above items excluded from adjusted net income are as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|--------------------|-----------------|
| | September 30, 2018 | October 1, 2017 | September 30, 2018 | October 1, 2017 |
| (MILLIONS OF DOLLARS) | | | | |
| Cost of sales: | | | | |
| Purchase accounting adjustments | \$9 | \$ 2 | \$13 | \$ 5 |
| Accelerated depreciation | — | — | — | 2 |
| Consulting fees | 1 | 2 | 4 | 4 |
| Other | — | (1) | — | — |
| Total Cost of sales | 10 | 3 | 17 | 11 |
| Selling, general & administrative expenses: | | | | |
| Purchase accounting adjustments | 11 | 1 | 14 | 4 |
| Consulting fees | — | — | — | 1 |
| Other | — | — | 1 | 2 |
| Total Selling, general & administrative expenses | 11 | 1 | 15 | 7 |
| Research & development expenses: | | | | |
| Purchase accounting adjustments | — | 1 | 1 | 2 |
| Total Research & development expenses | — | 1 | 1 | 2 |
| Amortization of intangible assets: | | | | |
| Purchase accounting adjustments | 29 | 19 | 67 | 55 |
| Total Amortization of intangible assets | 29 | 19 | 67 | 55 |
| Restructuring charges/(reversals) and certain acquisition-related costs: | | | | |
| Transaction costs | 21 | — | 21 | — |
| Integration costs | 9 | 2 | 10 | 4 |
| Employee termination costs | 17 | 7 | 22 | 3 |
| Exit costs | — | (1) | 1 | — |
| Total Restructuring charges/(reversals) and certain acquisition-related costs | 47 | 8 | 54 | 7 |
| Other (income)/deductions—net: | | | | |
| Net (gain)/loss on sale of assets | 2 | 4 | 2 | 6 |
| Other | (18) | — | (18) | (4) |
| Total Other (income)/deductions—net | (16) | 4 | (16) | 2 |
| Provision for taxes on income | 25 | 12 | 78 | 23 |
| Total purchase accounting adjustments, acquisition-related costs, and certain significant items—net of tax | \$56 | \$ 24 | \$60 | \$ 61 |

Certain amounts may reflect rounding adjustments.

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 30, 2018 vs. December 31, 2017

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

Accounts receivable, less allowance for doubtful accounts decreased as a result of the impact of foreign exchange and the timing of customer collections, partially offset by an increase due to the acquisition of Abaxis.

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Inventories increased as a result of the acquisitions of Abaxis and a manufacturing business in Ireland, and the rebuilding of safety stock levels based on the seasonality of our business, partially offset by the impact of foreign exchange.

Other current assets increased primarily as a result of higher receivables due to value-added tax for our international markets and an increase in fair value of certain derivative instruments.

The net changes in Deferred tax assets, Deferred tax liabilities, Income taxes payable and Other taxes payable primarily reflects the tax impacts of the acquisitions of Abaxis and a manufacturing business in Ireland, the adjustments to the accrual for the income tax provision, and the impact of the remeasurement of deferred taxes as a result of a change in tax rates. See Notes to Condensed Consolidated Financial Statements— Note 8. Income Taxes. Property, plant and equipment, less accumulated depreciation increased primarily as a result of capital spending and the acquisitions of Abaxis and a manufacturing business in Ireland, partially offset by depreciation expense.

Goodwill and Identifiable intangible assets, less accumulated depreciation increased as a result of the acquisition of Abaxis. See Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures and Note 10. Goodwill and other intangible assets.

Accounts payable decreased as a result of the timing of payments.

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

| | Nine Months | | |
|--|-------------|---------|--------|
| | Ended | | |
| | September | October | % |
| (MILLIONS OF DOLLARS) | 30, | 1, | Change |
| | 2018 | 2017 | |
| Net cash provided by (used in): | | | |
| Operating activities | \$1,206 | \$738 | 63 |
| Investing activities | (2,185) | (216) | * |
| Financing activities | 730 | 716 | 2 |
| Effect of exchange-rate changes on cash and cash equivalents | (29) | 16 | * |
| Net increase (decrease) in cash and cash equivalents | \$(278) | \$1,254 | * |

*Calculation not meaningful.

Certain amounts and percentages may reflect rounding adjustments.

Operating activities

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Net cash provided by operating activities was \$1,206 million for the nine months ended September 30, 2018, compared with net cash provided by operating activities of \$738 million for the nine months ended October 1, 2017. The increase in operating cash flows was primarily attributable to higher income before allocation to noncontrolling interests, as adjusted for depreciation and amortization, lower termination payments related to our operational efficiency initiative and supply network strategy, and the timing of receipts and payments in the ordinary course of business.

Investing activities

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Our net cash used in investing activities was \$2,185 million for the nine months ended September 30, 2018, compared with net cash used in investing activities of \$216 million for the nine months ended October 1, 2017. The net cash used in investing activities for 2018 was primarily due to the acquisitions of Abaxis and a manufacturing business in Ireland and purchases of property, plant and equipment. The net cash used in investing activities for 2017 was due primarily to purchases of property, plant and equipment, and the acquisitions of an Irish biologic therapeutics company and a Norwegian fish vaccination company.

Financing activities

Nine months ended September 30, 2018 vs. nine months ended October 1, 2017

Our net cash provided by financing activities was \$730 million for the nine months ended September 30, 2018, compared with net cash provided by financing activities of \$716 million for the nine months ended October 1, 2017. The net cash provided by financing activities for 2018 was primarily attributable to the issuance of senior notes in August 2018, partially offset by the purchase of treasury shares. The net cash provided by financing activities for 2017 was primarily attributable to proceeds received from the issuance of senior notes in September 2017, partially offset by the purchase of treasury shares and the payment of dividends.

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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.

Selected measures of liquidity and capital resources

Certain relevant measures of our liquidity and capital resources follow:

| | September 30, 2018 | December 31, 2017 |
|--|--------------------------|-------------------------|
| (MILLIONS OF DOLLARS) | | |
| Cash and cash equivalents | \$ 1,286 | \$ 1,564 |
| Accounts receivable, net ^(a) | 929 | 998 |
| Long-term debt, net of discount and issuance costs | 6,441 | 4,953 |
| Working capital | 3,073 | 3,123 |
| Ratio of current assets to current liabilities | 4.06:1 | 3.85:1 |

Accounts receivable are usually collected over a period of 45 to 75 days. For the nine months ended September 30, 2018, compared with December 31, 2017, the number of days that accounts receivables are outstanding remained approximately the same. We regularly monitor our accounts receivable for collectability, particularly in markets

^(a) 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, historical and expected collection patterns, the financial condition of our customers, the robust nature of our credit and collection practices and the economic environment.

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 2016, we entered into an amended and restated revolving credit agreement with a syndicate of banks providing for a five-year \$1.0 billion senior unsecured revolving credit facility (the credit facility). In December 2017, the maturity for the amended and restated revolving credit agreement was extended through December 2022. 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. Upon entering into a material acquisition, the maximum total leverage ratio increases to 4.00:1, and extends until the fourth full consecutive fiscal quarter ended immediately following the consummation of a material acquisition. The credit facility also contains a clause which adds back to Adjusted Consolidated EBITDA, any operational efficiency restructuring charge (defined as charges recorded by the company during the period commencing on October 1, 2016 and ending December 31, 2019, related to operational efficiency initiatives), provided that for any twelve-month period such charges added back to Adjusted Consolidated EBITDA shall not to exceed \$100 million in the aggregate.

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 30, 2018 and December 31, 2017. There were no amounts drawn under the credit facility as of September 30, 2018 or December 31, 2017.

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 30, 2018, we had access to \$75 million of lines of credit which expire at various times throughout 2018 and 2019 and are generally renewed annually. We did not have any

borrowings outstanding related to these facilities as of September 30, 2018 and December 31, 2017.

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). Actual repatriation of overseas funds can result in additional U.S. state income taxes, foreign withholding taxes and currency gains and losses. In addition, the recent changes imposed by the Tax Act resulted in a one-time deemed repatriation tax of previously untaxed accumulated and current earnings and profits of our foreign subsidiaries, which is payable over eight years with the first installment due in 2019.

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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 August 20, 2018, we issued \$1.5 billion aggregate principal amount of our senior notes (2018 senior notes), with an original issue discount of \$4 million. These notes are comprised of \$300 million aggregate principal amount of floating rate senior notes due 2021 (the "2018 floating rate senior notes") and \$300 million aggregate principal amount of 3.250% senior notes due 2021, \$500 million aggregate principal amount of 3.900% senior notes due 2028 and \$400 million aggregate principal amount of 4.450% senior notes due 2048 (collectively, the "2018 fixed rate senior notes"). Net proceeds from this offering were partially used to pay down and terminate a revolving credit agreement and repay outstanding commercial paper, which were borrowed to finance a portion of the cash consideration for the acquisition of Abaxis (see Notes to Condensed Consolidated Financial Statements— Note 5. Acquisitions and Divestitures). The remainder of the net proceeds will be used for general corporate purposes.

On September 12, 2017, we issued \$1.25 billion aggregate principal amount of our senior notes (2017 senior notes), with an original issue discount of \$7 million. These notes are comprised of \$750 million aggregate principal amount of 3.000% senior notes due 2027 and \$500 million aggregate principal amount of 3.950% senior notes due 2047. Net proceeds from this offering were partially used in October 2017 to repay, prior to maturity, the aggregate principal amount of \$750 million, and a make-whole amount and accrued interest of \$4 million, of our 1.875% senior notes due 2018. The remainder of the net proceeds will be used for general corporate purposes.

On November 13, 2015, we issued \$1.25 billion aggregate principal amount of our senior notes (2015 senior notes), with an original issue discount of \$2 million. On January 28, 2013, we issued \$3.65 billion aggregate principal amount of our senior notes (2013 senior notes) in a private placement, with an original issue discount of \$10 million.

The 2013, 2015, 2017 and 2018 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 lease-back 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 (if not cured or waived), the 2013, 2015, 2017 and 2018 senior notes may be declared immediately due and payable.

Pursuant to the indenture, we are able to redeem the 2013, 2015 and 2017 senior notes and the 2018 fixed rate 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. The 2018 floating rate senior notes are not redeemable at our option prior to their maturity date. Pursuant to our tax matters agreement with Pfizer, we will not be permitted to redeem the 2013 senior notes due 2023 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 2013, 2015, 2017 and 2018 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 2013, 2015, 2017 and 2018 senior notes at a price equal to 101% of the aggregate principal amount of the 2013, 2015, 2017 and 2018 senior notes together with accrued and unpaid interest to, but excluding, the date of repurchase.

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

| Description | Principal Amount | Interest Rate | Terms |
|---|------------------|---------------|--|
| 2015 Senior Note due 2020 | \$500 million | 3.450% | Interest due semi annually, not subject to amortization, aggregate principal due on November 13, 2020 |
| 2018 Floating Rate Senior Note due 2021 | \$300 million | Floating | Interest due quarterly, not subject to amortization, aggregate principal due on August 20, 2021 |
| 2018 Senior Note due 2021 | \$300 million | 3.250% | Interest due semi annually, not subject to amortization, aggregate principal due on August 20, 2021 |
| 2013 Senior Note due 2023 | \$1,350 million | 3.250% | Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2023 |
| 2015 Senior Note due 2025 | \$750 million | 4.500% | Interest due semi annually, not subject to amortization, aggregate principal due on November 13, 2025 |
| 2017 Senior Note due 2027 | \$750 million | 3.000% | Interest due semi annually, not subject to amortization, aggregate principal due on September 12, 2027 |
| 2018 Senior Note due 2028 | \$500 million | 3.900% | Interest due semi annually, not subject to amortization, aggregate principal due on August 20, 2028 |
| 2013 Senior Note due 2043 | \$1,150 million | 4.700% | Interest due semi annually, not subject to amortization, aggregate principal due on February 1, 2043 |
| 2017 Senior Note due 2047 | \$500 million | 3.950% | Interest due semi annually, not subject to amortization, aggregate principal due on September 12, 2047 |
| 2018 Senior Note due 2048 | \$400 million | 4.450% | Interest due semi annually, not subject to amortization, aggregate principal due on August 20, 2048 |

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 | | | |
|-----------------------|------------|----------------|---------|---------------------|
| | Paper | Long-term Debt | Outlook | Date of Last Action |
| Moody's | P-2 | Baa1 | Stable | August 2017 |
| S&P | A-2 | BBB | Stable | December 2016 |

Share Repurchase Program

In December 2016, the company's Board of Directors authorized a \$1.5 billion 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 of 2018, approximately 7 million shares were repurchased. As of September 30, 2018, there was approximately \$451 million remaining under this authorization.

Contractual obligations

In connection with the acquisition of Abaxis in the third quarter of 2018, we have additional contractual obligations as follows:

| (MILLIONS OF DOLLARS) | Total | 2018 | 2019 | 2020 | 2021-2022 | Thereafter |
|-----------------------------|-------|------|------|------|-----------|------------|
| Operating lease commitments | \$ 26 | \$ 1 | \$ 8 | \$ 6 | \$ 11 | |
| Purchase obligations | 25 | 3 | 22 | — | — | |

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 30, 2018, or December 31, 2017, 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 30, 2018.

In August, 2018, the FASB issued an accounting standards update which expands the scope of costs associated with cloud computing arrangements that must be capitalized. Under the new guidance, costs associated with implementing a cloud computing arrangement that is a service contract must be capitalized and expensed over the term of the hosting arrangement. The provisions of the update are effective beginning January 1, 2020 for interim and annual periods with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption as well as the potential impact that the standard will have on our consolidated financial statements.

In February 2018, the FASB issued an accounting standards update which permits companies to reclassify from accumulated other comprehensive income to retained earnings stranded tax effects resulting from the new federal corporate income tax rate. In the period of adoption, a company may choose to either apply the amendments retrospectively to each period in which the effect of the change in federal income tax rate is recognized or to apply the amendments in that reporting period. The provisions of the update are effective beginning January 1, 2019 for interim and annual periods, with early adoption permitted for any interim period after issuance of the update. We are currently assessing the timing of our adoption and do not expect that the new standard will have a significant impact on our consolidated financial statements.

In February 2016, the FASB issued an accounting standards update which requires lessees to recognize most leases on the balance sheet with a corresponding right of use asset. Leases will be classified as financing or operating which will drive the expense recognition pattern. For lessees, the income statement presentation and expense recognition pattern for financing and operating leases is similar to the current model for capital and operating leases, respectively. Companies may elect to exclude short-term leases. The update also requires additional disclosures that will better enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. We plan to adopt this guidance as of January 1, 2019, using the effective date as the date of initial application. As permitted, utilizing an optional transition method, a cumulative-effect adjustment to the opening balance of retained earnings will be recognized in the period of adoption, and financial information and disclosure for periods prior to the date of initial application will not be updated. We have selected a lease accounting system which we are in

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the process of implementing, while continuing to evaluate our lease contracts, accounting policy elections, and the impact of adoption on our consolidated financial statements. While we do not expect adoption of the standard to have a significant impact on our consolidated statements of income, the impact on the assets and liabilities within our consolidated balance sheet will be material.

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 2018 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, integration of acquired businesses, interest rates, tax rates, changes in tax regimes and laws, 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, 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 based on 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:

- 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;
- unanticipated safety, quality or efficacy concerns about or issues related to 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;
- legal factors, including product liability claims, antitrust litigation and governmental investigations, 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;
- consolidation of our customers and distributors negatively affecting the pricing of our products;
- 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;
- changes in tax laws and regulations, in the United States and other countries, 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 potential future interpretative guidance related to the recently passed Tax Act or new legislative 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.

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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 Australian dollar, Brazilian real, Canadian dollar, Chinese renminbi, euro, and U.K. pound. 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 30, 2018, 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 30, 2018, 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 \$21 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 \$26 million. For additional details, see Notes to Condensed Consolidated Financial Statements— Note 9C. Financial Instruments: Derivative Financial Instruments— Foreign Exchange Risk.

Interest rate risk

Our outstanding debt balances are predominantly 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 \$300 million 2018 Floating Rate Senior Note due 2021, as well as interest on our commercial paper and revolving credit facility will be exposed to interest rate fluctuations. At September 30, 2018, there were no commercial paper borrowings outstanding and no outstanding principal balance under our revolving credit facility. See Notes to Condensed Consolidated Financial Statements— Note 9C. Financial Instruments: Derivative Financial Instruments— Interest Rate Risk.

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 30, 2018, 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

On July 31, 2018, the company completed the acquisition of Abaxis, Inc. (Abaxis). As a result, the company is currently integrating policies, processes, people, technology and operations related to this acquisition, and will continue to evaluate the impact of any related changes to internal control over financial reporting. Except for changes in internal control over financial reporting relating to the integration of Abaxis, 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.

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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 Statements and Factors That May Affect Future Results" sections of the MD&A and in Part I, Item 1A. "Risk Factors," of our 2017 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 2017 Annual Report on Form 10-K.

Risks related to our business and industry

Modification of foreign trade policy by the U.S. or foreign countries or the imposition of tariffs on U.S. or foreign goods may harm our business.

Changes in U.S. laws, agreements and policies governing foreign trade in the territories and countries where our customers do business could negatively impact such customers' businesses and adversely affect our operating results. A number of our customers, particularly U.S.-based livestock producers, benefit from free trade agreements such as the North American Free Trade Agreement (NAFTA). The U.S., Canada and Mexico reached an agreement to replace the NAFTA with the United States-Mexico-Canada Agreement (USMCA). Most of the provisions of the USMCA will not begin until 2020. These new provisions, as well as any other changes to international trade agreements or policies could harm our customers, and as a result, negatively impact our financial condition and results of operations. Additionally, in March 2018, the United States announced tariffs on certain foreign goods imported into the U.S. In response, some foreign governments, including China, have instituted or are considering instituting tariffs on certain U.S. goods. While the scope and duration of these and any future tariffs remains uncertain, tariffs imposed by the U.S. or foreign governments on our products or the active pharmaceutical ingredients or other components thereof could negatively impact our financial condition and results of operations.

Risks related to tax matters

The Company could be subject to changes in its tax rates, the adoption of new U.S. or foreign tax legislation or exposure to additional tax liabilities.

The multinational nature of our business subjects us to taxation in the United States and numerous foreign jurisdictions. Due to economic and political conditions, tax rates in various jurisdictions may be subject to significant change. The company's future effective tax rates could be affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, or changes in tax laws or their interpretation.

For example, the European Commission opened formal investigations to examine whether decisions by the tax authorities in certain European countries, including Belgium, comply with European Union rules on state aid. In the case of Belgium, the European Commission concluded on January 11, 2016, that the excess profits ruling violates the European Union's state aid rules.

In addition, on June 20, 2016, the Member States of the European Union adopted the anti-tax-avoidance directive proposed on January 28, 2016, which is designed to provide uniform implementation of Base Erosion and Profits Shifting measures and other minimum taxation standards across Member States. The Member States are required to implement all components of the directive by January 1, 2020. Once enacted by the Member States, the results of the directive could have an impact on our effective tax rate. In October 2016, the European Union also introduced a proposal to impose a uniform set of rules on taxing corporate profits, known as the Common Consolidated Corporate Tax Base. This proposal is still under consideration and may have an impact to our effective tax rate.

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the Tax Act) effective January 1, 2018. Some notable provisions of the Tax Act include a reduction of the corporate income tax rate from 35% to 21%, and a change from a worldwide system with deferral to a territorial tax system, which includes a one-time mandatory deemed repatriation tax, payable over eight years, on certain undistributed earnings of non-U.S. subsidiaries. As of

December 31, 2017, the cumulative amount of non-U.S. undistributed earnings was approximately \$4.5 billion, which includes an allocation of non-U.S. undistributed earnings as a result of the separation from Pfizer on June 24, 2013. Pursuant to the Staff Accounting Bulletin published by the Securities and Exchange Commission on December 22, 2017, addressing the challenges in accounting for the effects of the Tax Act in the period of enactment, companies must report provisional amounts for those specific income tax effects of the Tax Act for which the accounting is incomplete but a reasonable estimate can be determined. Those provisional amounts will be subject to adjustment during a measurement period of up to one year from the enactment date. The company is currently in the process of evaluating the full impact of this new legislation on its consolidated financial statements, and in the fourth quarter of 2017 recorded a provisional net charge of \$212 million related to the one-time mandatory deemed repatriation tax, partially offset by the remeasurement of the deferred tax assets and liabilities, as of the date of enactment, due to the reduction in the U.S. federal corporate tax rate. A measurement-period adjustment was recorded in the nine months of 2018 as a decrease to income tax expense of \$58 million. At this time, we are properly reflecting the provision for taxes on income using all current enacted global tax laws in every jurisdiction in which we operate.

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On March 29, 2017, United Kingdom (UK) Prime Minister Theresa May formally notified the European Council of the UK's intention to withdraw from the European Union, commonly referred to as "Brexit", under Article 50 of the Treaty of Lisbon. The notice begins the two-year negotiation period to establish the withdrawal terms. If no agreement is reached after two years, the UK's separation still becomes effective, unless the remaining European Union members unanimously agree to an extension. At this time, the impact of Brexit to our effective tax rate is uncertain.

In addition, our effective tax rate is subject to potential risks that various taxing authorities may challenge the pricing of our cross-border arrangements and subject us to additional tax, adversely impacting our effective tax rate and our tax liability. The company is also subject to the examination of its tax returns and other tax matters by the Internal Revenue Service and other tax authorities and governmental bodies. The company regularly assesses the likelihood of an adverse outcome resulting from these examinations to determine the adequacy of its provision for taxes. There can be no assurance as to the outcome of these examinations. If the company's effective tax rates were to increase, particularly in the United States or other material foreign jurisdictions, or if the ultimate determination of the company's taxes owed is for an amount in excess of amounts previously accrued, the company's operating results, cash flows and financial condition could be adversely affected.

Risks related to our indebtedness

We have substantial indebtedness.

We have a significant amount of indebtedness, which could materially adversely affect our operating results, financial condition and liquidity. As of September 30, 2018, we had approximately \$6.4 billion of total unsecured indebtedness outstanding. In addition, we currently have agreements for a multi-year revolving credit facility with a capacity of up to \$1.0 billion and a commercial paper program with a capacity of up to \$1.0 billion. While we currently do not have any amounts drawn under the credit facility nor any commercial paper issued under the commercial paper program, we may incur indebtedness under these arrangements in the future.

We may incur substantial additional debt from time to time to finance working capital, capital expenditures, investments or acquisitions, or for other purposes. If we do so, the risks related to our high level of debt could intensify. Specifically, our high level of debt could have important consequences, including:

- making it more difficult for us to satisfy our obligations with respect to our debt;
- limiting our ability to obtain additional financing to fund future working capital, capital expenditures, business development or other general corporate requirements, including dividends;
- increasing our vulnerability to general adverse economic and industry conditions;
- exposing us to the risk of increased interest rates as certain of our borrowings are and may in the future be at variable rates of interest;
- limiting our flexibility in planning for and reacting to changes in the animal health industry;
- placing us at a competitive disadvantage to other, less leveraged competitors;
- impacting our effective tax rate; and
- increasing our cost of borrowing.

In addition, the instruments governing our indebtedness contain restrictive covenants that will limit our ability to engage in activities that may be in our long-term best interest. For example, our credit facility contains a financial covenant requiring us to not exceed a maximum total leverage ratio and covenants that, among other things, limit or restrict our and our subsidiaries' ability, subject to certain exceptions, to incur liens, merge, consolidate or sell, transfer or lease assets, transact with affiliates and incur priority indebtedness. Our failure to comply with such covenants could result in an event of default which, if not cured or waived, could result in the acceleration of all our debt.

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 30, 2018:

| Issuer Purchases of Equity Securities | | | |
|---|------------------------------|--|--|
| Total Number of Shares Purchased ^(a) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs ^(b) | Approximate Dollar Value of Shares that May Yet Be Purchased Under Plans or Programs |
| 555,908 | \$85.49 | 555,059 | \$547,016,075 |

| | | | | |
|--|-----------|---------|-----------|---------------|
| July 1 - July 31, 2018 | | | | |
| August 1 - August 31, 2018 | 561,240 | \$90.28 | 561,238 | \$496,348,315 |
| September 1 - September 30, 2018 | 502,198 | \$89.38 | 502,060 | \$451,388,731 |
| | 1,619,346 | \$88.36 | 1,618,357 | \$451,388,731 |

(a) The company repurchased 989 shares during the three-month period ended September 30, 2018, 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.

(b) In December 2016, the company's Board of Directors authorized the repurchase of up to \$1.5 billion 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 (File No. 001-35797))

Exhibit 3.2 By-laws of the Registrant, amended and restated as of February 19, 2016 (incorporated by reference to Exhibit 3.2 to Zoetis Inc.'s 2015 Annual Report on Form 10-K filed on February 24, 2016 (File No. 001-35797))

Exhibit 10.1 Zoetis Inc. Amended and Restated Non-Employee Director Deferred Compensation Plan

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

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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 1, 2018 By: /S/ JUAN RAMÓN ALAIX

Juan Ramón Alaix

Chief Executive Officer and Director

November 1, 2018 By: /S/ GLENN DAVID

Glenn David

Executive Vice President and

Chief Financial Officer