27th April 2016

Healthcare

GlaxoSmithKline

Price 1,459p

Strong start to the year, including favourable phasing

Fair Value 1700p vs. 1670p (+17%) **BUY**

Bloomberg	GSK LN
Reuters	GSK.L
12-month High / Low (p)	1,562 / 1,238
Market Cap (GBPm)	71,040
Ev (BG Estimates) (GBPm)	97,723
Avg. 6m daily volume (000)	8 379
3y EPS CAGR	11.3%

	1 M	3 M	6 M	31/12/15
Absolute perf.	5.0%	3.0%	6.5%	6.2%
Healthcare	5.0%	-3.7%	-8.4%	-8.7%
DJ Stoxx 600	3.6%	2.4%	-7.6%	-5.1%

YEnd Dec. (GBPm)	2015	2016e	2017e	2018e
Sales	23,923	25,866	26,611	27,285
% change		*8.1%*	*2.9%*	*2.5%*
EBITDA	7,429	8,805	9,466	9,606
EBIT	5,729	7,105	7,766	7,906
% change		*24.0%*	*9.3%*	*1.8%*
Net income	3,658	4,366	4,810	5,058
% change		*19.4%*	*10.2%*	*5.2%*

	2015	2016e	2017e	2018e
Operating margin	23.9	27.5	29.2	29.0
Net margin	15.3	16.9	18.1	18.5
ROE	78.0	88.0	89.5	76.1
ROCE	14.7	17.4	18.6	19.0
Gearing	118.9	124.1	94.7	65.1

(p)	2015	2016e	2017e	2018e
EPS	75.71	90.08	96.03	104.35
% change	-	*19.0%*	*6.6%*	*8.7%*
P/E	19.3x	16.2x	15.2x	14.0x
FCF yield (%)	2.7%	5.6%	6.9%	8.1%
Dividends (p)	100.00	80.00	80.00	88.00
Div yield (%)	6.9%	5.5%	5.5%	6.0%
EV/Sales	4.0x	3.8x	3.6x	3.5x
EV/EBITDA	13.0x	11.1x	10.2x	9.9x
EV/EBIT	16.9x	13.8x	12.5x	12.0x

At mid session yesterday, GSK reported first-quarter earnings that were comfortably above estimates with both top-line and margins healthier than expected. The two majors beats at the revenue level stemmed from an under-estimated full-quarter consolidation impact from Novartis' CHC business and from favourable phasing in vaccine shipments and tenders. Together with seasonality and some positive mix effects, these two elements also boosted Q1 margins to a level that will not be sustainable over the year. In all, we would say that while Q1 earnings were pleasant and support our investment thesis, they have less of an impact on FY numbers than thought hence a modest FV move.

ANALYSIS

- Yesterday, GSK's numbers came out well above estimates, beating sales (up 8% at CER) by about GBP300m and core EPS (up 8% at CER) by 10%, despite an increase in the number of shares used for computation.
- Going through the whole portfolio, it was hard finding big differences in individual pharma products and honestly we would even say that there were more disappointments than nice surprises, from Nucala (only GBP7m) to Breo and Anoro. Only Triumeq was above estimates, once again, but more marginally than in previous quarters. Actually the clear outperformers were Vaccines and CHC by respectively GBP60m and GBP200m. Pro-forma vaccine sales grew 14% during the quarter, helped by strong organic growth from Meningitis vaccines Menveo and Bexsero but also by a different phasing in orders for Synflorix. A significant part of the difference is expected to be reversed in coming quarter(s). As far as CHC goes, the difference is huge and we, as well as the consensus, did not properly factor in the full-quarter impact of a strong quarter for the former Novartis business (one month in Q1 2015 and three months in Q1 2016). Underlying growth was 4% but reported growth excluding currencies was 26% and obviously we did not fully capture this scope impact. Performance of Flonase OTC during the quarter was also particularly strong.
- These two businesses were also behind the surprise for the rest of the P&L as their respective operating margins meaningfully exceeded previous quarters' levels and estimates. Core operating margin in vaccines jumped from 26.4% on average in 2015 to 28.7% in Q1 2016 and although it is headed to the "north of 30%" target, it may not be the full-year level as some positive effects seen in Q1 will not repeat. The same is true for CHC where core margin was 17.2% (vs 13.2% in Q1 2015 and 11.3% on average in 2015). This already significant improvement reflects concentration on core brands and cost reductions including synergies with Novartis (80% of sites are closed and 90% of people decisions implemented). But here again, seasonality in the business and particularly strong quarter for Flonase had positive mix effects that cannot be extrapolated over the full year.

VALUATION

- We have revised our assumptions for full-year CHC revenues and more marginally for CHC operating margin. This was behind most of our revised numbers for 2016. That said, we had already been bullish with margin increase over the years and so this is mainly a quicker uptake this year with no change over the medium-term (we have 20-21% in 2019). This is why our FV is only modestly impacted by GBp30 to GBp1,700. However, our investment thesis is more than endorsed by these results and the quarterly release strengthens our BUY rating.
- Now we see two main potential FV drivers on the upside: the first is R&D as few new products are currently included into our sales model and the second is fresh impetus from new CEO.

NEXT CATALYSTS

- 12th May 2016: ex-Q1 dividend date (GBp19 per share)

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