

Novartis

Price CHF74.55

How close is the bottom?

Fair Value CHF88 vs. CHF95 (+18%)

NEUTRAL

Bloomberg	NOVN VX
Reuters	NOVN.VX
12-month High / Low (CHF)	102.3 / 68.5
Market Cap (CHF)	199,570
Ev (BG Estimates) (CHF)	202,995
Avg. 6m daily volume (000)	6,025
3y EPS CAGR	5.7%

	1 M	3 M	6 M	31/12/15
Absolute perf.	4.7%	-7.0%	-15.0%	-14.1%
Healthcare	6.3%	1.3%	-2.5%	-7.3%
DJ Stoxx 600	2.6%	6.4%	-3.6%	-4.4%

YEnd Dec. (USDm)	2015	2016e	2017e	2018e
Sales	49,414	50,147	52,651	55,882
% change		1.5%	5.0%	6.1%
EBITDA	13,119	12,998	13,864	15,382
EBIT	7,544	7,498	8,364	9,882
% change		-0.6%	11.6%	18.1%
Net income	6,017	6,569	7,639	9,141
% change		9.2%	16.3%	19.7%

	2015	2016e	2017e	2018e
Operating margin	15.3	15.0	15.9	17.7
Net margin	12.2	13.1	14.5	16.4
ROE	8.1	8.5	9.9	11.7
ROCE	14.4	13.4	14.7	16.9
Gearing	21.4	22.5	20.9	16.6

(USD)	2015	2016e	2017e	2018e
EPS	5.01	4.96	5.29	5.92
% change	-	-1.0%	6.8%	11.8%
P/E	15.3x	15.5x	14.5x	12.9x
FCF yield (%)	0.6%	3.2%	4.7%	5.2%
Dividends (USD)	2.75	3.00	2.65	2.96
Div yield (%)	3.6%	3.9%	3.5%	3.9%
EV/Sales	4.2x	4.2x	3.9x	3.7x
EV/EBITDA	15.8x	16.1x	15.0x	13.3x
EV/EBIT	27.6x	27.8x	24.8x	20.7x

Novartis has clearly said that Q2 will be another tough quarter, but at the same time, it seems that the two issues that are weighing on the stock are being addressed and we see very little, if any, further downside risk on Alcon and Entresto. While we acknowledge that short-term catalysts are rare, we approach the next three months as a potential turning point with longer-term triggers on the horizon in the pipeline. We adjust our FV mainly to include safer estimates for Entresto and are maintaining our NEUTRAL recommendation until we have further and clearer evidence that a turning point is getting closer.

ANALYSIS

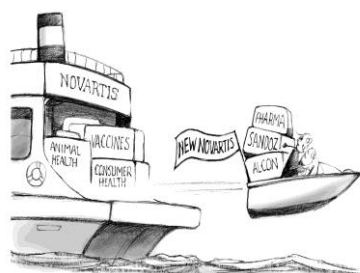
- We think it is a fair question to ask how far the bottom might be for Novartis because although Alcon and Entresto remain two hot topics not yet fully addressed, we see them more or less risk-adjusted by the consensus whereas mitigating factors are starting to emerge more clearly as well as some (admittedly more mid-term) upsides from the pipeline.
- During yesterday's conference call, Novartis management made its best effort to address the two recurring negative questions that weigh on the stock i.e. Alcon and Entresto. On Alcon, time was left to the new Head of division to share his confidence in turning the business around and bringing it back to growth by year-end. That said, he did not commit himself to any targets as it is premature to say how quick patients and physicians will react to new marketing initiatives that are being put in place. On Entresto, as expected, Novartis showed charts supporting the thesis of a quicker take-off in Europe vs the US while also trying to reassure about the US situation. Now that reimbursement has improved, Novartis is ready to spend more on marketing, has increased the sales force by 50%, started a DTC campaign and is considering starting promotion towards PCPs. And USD5bn in peak sales was reaffirmed. We do not see how things could get worse here.
- Simultaneously, Novartis pointed out that Cosentyx is exceeding internal expectations by far and is not worried by upcoming competition from Lilly's drug as superior safety should offset perceived lower efficacy. Moreover, the opportunity in rheumatology is untapped as yet and nevertheless highly significant. The group also stressed four ongoing developments in phase III trials that each have blockbuster potential (LEE011, Fovista, AMG334, serelaxin). We have only two out of the four in our models with low probabilities of success. Soon filing of biosimilars rituximab and adalimumab in the US and Europe also remind us that Sandoz should benefit from higher top and bottom-line exposure to biosimilars in coming years. Here again, we have little to no expectations in our model as we have always had trouble in sizing the opportunity and determining the right timing for product launches.

VALUATION

- So, in summary, we are approaching the bottom as no new warning is emerging. We see catalysts on the horizon. But we are still lacking short-term momentum as the CFO himself said that Q2 would show the biggest earnings decline with the combination of higher marketing expenses for Alcon, Entresto and Cosentyx, the full generic impact on Gleevec and the end to the positive perimeter effect from the GSK asset swap. The CFO talked about a high single digit decline in core EBIT to be expected in Q2.
- In this context, we see Q2 2016 as a potential turning point for the story and to some extent, the Meet the Management Meeting due on 24-25th May 2016 in Basel can be seen as a catalyst that could help fine-tune impacts from currently under-estimated products and assets.
- We think this is the right time to put ourselves on a safer side re Entresto too. As such, we have reduced the net average selling price and penetration while putting 0 for the pEF opportunity (vs 20% PoS before), thereby reducing peak sales from USD5.5bn to USD4.1bn. This is largely behind our FV adjustment today but should we get closer to an inflexion point, we think it is the right thing to do.

NEXT CATALYSTS

- 24-25 May 2016: Meet The Management Meeting in Basel - [Click here to download](#)



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