

19th July 2016

Healthcare

**Novartis**

Price CHF80.45

**Q2 ahead of expectations; FY guidance adjusted to support investments behind Entresto**

Fair Value CHF89 (+11%)

**NEUTRAL**

Bloomberg	NOVN VX
Reuters	NOVN.VX
12-month High / Low (CHF)	102.3 / 68.5
Market Cap (CHFm)	211,351
Ev (BG Estimates) (CHFm)	202,750
Avg. 6m daily volume (000)	5 814
3y EPS CAGR	5.5%

Novartis delivered a solid set of quarterly figures this morning. Revenues came out about USD200m ahead of expectations and core EPS 2% above estimates too. Activity was largely driven by a good performance in Innovative Medicines, whose core operating margin declined only 150bp despite loss of Gleevec for the first time for full quarter. However, we assume that comments will focus on the adjustment of full-year core operating income guidance, which says that depending on Gleevec curve, it may be slightly down (vs flat previously) as a consequence of increased investments behind Entresto. Although it may hit the stock at the opening, CS numbers are already aligned.

	1 M	3 M	6 M	31/12/15
Absolute perf.	7.5%	9.0%	0.1%	-7.3%
Healthcare	9.0%	4.2%	5.0%	-4.2%
DJ Stoxx 600	4.0%	-1.6%	3.1%	-7.4%

**ANALYSIS**

YEnd Dec. (USDm)	2015	2016e	2017e	2018e
Sales	49,414	49,989	52,254	55,558
% change		1.2%	4.5%	6.3%
EBITDA	13,119	12,948	13,729	15,277
EBIT	7,544	7,448	8,229	9,777
% change		-1.3%	10.5%	18.8%
Net income	6,017	6,526	7,523	9,051
% change		8.5%	15.3%	20.3%

	2015	2016e	2017e	2018e
Operating margin	15.3	14.9	15.7	17.6
Net margin	12.2	13.1	14.4	16.3
ROE	8.1	8.5	9.8	11.5
ROCE	14.4	13.3	14.5	16.8
Gearing	21.4	22.6	20.9	16.3

(USD)	2015	2016e	2017e	2018e
EPS	5.01	4.94	5.25	5.88
% change	-	-1.4%	6.2%	12.2%
P/E	16.3x	16.5x	15.6x	13.9x
FCF yield (%)	0.6%	3.0%	4.3%	4.8%
Dividends (USD)	2.75	3.00	2.62	2.94
Div yield (%)	3.4%	3.7%	3.2%	3.6%
EV/Sales	4.2x	4.1x	3.9x	3.6x
EV/EBITDA	15.6x	15.9x	14.9x	13.2x
EV/EBIT	27.2x	27.7x	24.9x	20.6x

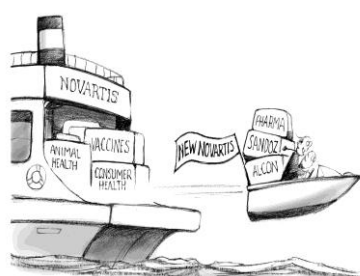
- Novartis has delivered a good set of quarterly numbers today with revenues flat in constant currencies at USD12.47bn, reflecting a decline by 1% with Innovative Medicines and Alcon offset by a progression of 3% in Sandoz sales. Consensus was expecting USD12.2bn and most of the difference comes from the Pharma division.
- Actually the difference of roughly USD200m is over 50% from Gleevec, whose resilience is amazing since the drug was down only 48% in the US during the quarter i.e. marginally more than in Q1 although full quarter was impacted by the first generic. Until the entrance of several new generics at the very beginning of August, it is fair to say that Novartis has kept the decline under strict control and so sales were about USD110m ahead of estimates during the quarter. To a certain extent, it can be said that same happened with Diovan which was also more resilient than expected (-13%) and generated another positive difference by about USD30m. These two elements are good for Novartis during the quarter, but are unlikely to persist as generic competition will intensify and spread from a geographic perspective. The third source of difference vs consensus numbers is more representative of a growth driver for the future as it comes from Cosentyx that delivered a spectacular sequential growth in Q2, reaching USD260m in the quarter, well ahead of Stelara and now including a meaningful contribution from ex-US territories (USD80m), suggesting a commercial success across all geographies. Beyond those drugs, it is also worth mentioning good performance from Gilenya (up 17% to USD811m) and worsening decline of Afinitor in the US (-22%) with no surprise.
- Moving to the other two businesses, we see less to no surprise here compared to what consensus was expecting. Sandoz grew less than in Q1 but mainly due to a stronger comparison base. Core operating income was almost flat despite recurring high investments to prepare for the next wave of launches in the biosimilar space. To report here the issuance of a CRL by the FDA about Neulasta biosimilar for which Sandoz is preparing answers and that should delay a launch by a few months into 2017. As long as Alcon, the press release reports “progress on innovation” while it is continuing to invest to accelerate innovation and sales. So far the inflexion is minimal as revenues were still down 1% in the quarter whereas margin dropped 290bp to 15.8%, but we see no surprise here compared to previous statements.
- In the end, the key element from today’s press release is the slight adjustment made to the guidance for core operating income growth in 2016. From flat, it is now believed to be flat to slightly negative depending on the speed of decline in Gleevec sales, as a consequence of an increased investment in marketing and sales behind Entresto. Because guideline updates came earlier than expected, Novartis has decided to double its sales force targeting GPs in the US from 600 to about 1,200 for an extra cost of USD200m. We believe the drug deserves this extra investment because despite a disappointing start in the US, its potential looks intact.

**VALUATION**

- We believe that changes to implement will be minor. To note is that consensus already expects a core EBIT decline by 5%, suggesting underlying cc decline of 2-3%, in line with the new guidance.

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