

AstraZeneca

United Kingdom/Pharmaceuticals
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UBS Research

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Demystifying MYSTIC's statistics. Reiterate Buy

- Today we reiterate our Buy rating on AstraZeneca
- MYSTIC seen as a big leap towards sustained pricing power
- Why oncology?
- Valuation:

We believe the market is failing to distinguish pharma sub-segments that will retain pricing power from those that won't. AstraZeneca trying to reinvent itself; cannibalizing old lines of business to invest in oncology, where pricing power is likely sustainable. We think the next news on the reinvention, from the MYSTIC trial in H2 2017, will likely suggest that things are working. We would expect a substantial stock move on the news and a re-rating thereafter. We forecast core EPS CAGR near 10% from 2017E to 2023E.

MYSTIC seen as a big leap towards sustained pricing power

MYSTIC is the first in a series of trials of immuno-oncology combinations in the lucrative first-line lung cancer market. If MYSTIC works, markets will likely have more confidence that AZN is transforming. We think markets assign too high a probability to trial failure. We have thrown our considerable statistical geekery at MYSTIC (Monte-Carlo simulations, consultations with statisticians and trial design experts, etc., etc.) and assume an 80% probability of good news in H1 2017.

Why oncology?

We have done work with health systems, and the UBS team includes individuals with experience in pricing and market access. We believe pricing power is more sustainable in oncology; protected by a mixture of legislation, mainly in the US; medical urgency; complexity, which gives companies the option to generate evidence that differentiates otherwise similar drugs; and a higher rate of innovation from a benign regulatory environment, unusually informative early-stage trials, and a variety of "-omics" that match drugs to patients. Much of the uptick in drug approvals from '12 has been oncology driven, with 45 of the 152 newly approved drugs having cancer labels.

Valuation:

We focus on DCF in setting price targets, but sense-check vs. PE multiples for "core" and IFRS earnings, considering EPS growth profile. Our new target for AZN is 5,000p. This is 15.4x 2018e "core" and 27.6x 2018e IFRS earnings. Our sector "core" '18E target multiple is 14.2x but we see AZN as having good growth. Our EPS is 10% below sell-side consensus in the outer years, but valuation suggests that buy-side consensus is lower still.

| | |
|-----------------------|--------------------|
| 12-month rating | Buy |
| 12-month price target | 5,000.00p |
| Prior | 5,480p |
| Price | 4,055.00GBp |

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Trading data and key metrics

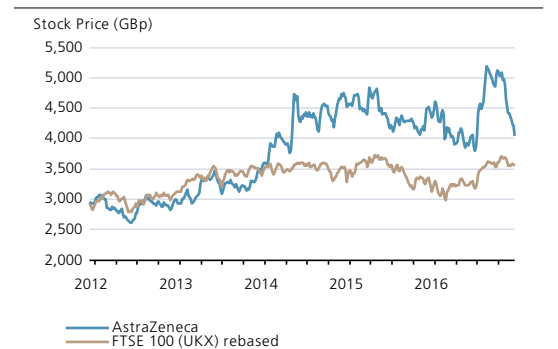
| | |
|----------------------------|--------------------|
| 52-wk range | 5,220p-3,774 |
| Market cap. | £50.8bn/US\$64.5bn |
| Shares o/s | 1,252m (ORD) |
| Free float | 99% |
| Avg. daily volume ('000) | 2,699 |
| Avg. daily value (m) | £126.8 |
| Common s/h equity (12/16E) | US\$17.2bn |
| P/BV (12/16E) | 3.8x |
| Net debt / EBITDA (12/16E) | 1.0x |
| RIC | AZN.L |
| BBG | AZN LN |

Sources: UBS, Bloomberg

EPS (UBS, diluted) (US\$)

| | From | To | % ch | Cons. |
|--------|------|------|------|-------|
| 12/16E | 4.02 | 4.36 | 8 | 4.23 |
| 12/17E | 4.08 | 3.82 | -6 | 3.76 |
| 12/18E | 4.42 | 4.11 | -7 | 4.15 |

Performance



Sources: Bloomberg, UBS

Definitions of terms and abbreviations are available in the appendix section of this report, and more extensively on internet at www.ubs.com/glossary

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Investment Thesis

Investment Case

We have a Buy rating on AstraZeneca for two reasons. We believe the market is failing to distinguish pharma sub-segments that will retain pricing power from those that won't. AstraZeneca trying to reinvent itself; cannibalizing old lines of business to invest in oncology, where pricing power is likely sustainable. The next news on the reinvention, from the MYSTIC trial in H2 2017, will likely suggest that things are working. We expect a substantial stock move on the news and a re-rating thereafter. We forecast core EPS CAGR near 10% from 2017E to 2023E.

Company Profile: AstraZeneca

AstraZeneca is an Anglo-Swedish large-cap pharmaceutical company. It is transforming a portfolio once dominated by maturing blockbusters (Crestor, Symbicort, Nexium) to one driven by 6 growth platforms: Emerging Markets, Japan, Respiratory, Diabetes, New Oncology (Iressa, Tagrisso, Lynparza) and Brilinta. The company typically generates revenue from non-core areas through externalisation e.g. Plendil (CMS), anaesthetics (Aspen). AZN invests heavily in R&D with key projects in immuno-oncology (durvalumab, tremelimumab), classic oncology (targeting the DDR pathway) and cardiometabolic (roxadustat and ZS-9).

Statement of Risk

Company risks include: AstraZeneca is heavily reliant on its pipeline products and new launches for future growth; hence an accumulation of pipeline setbacks could jeopardize the ongoing turnaround. AZN's pipeline success is heavily dependent on their success in immuno-oncology which is an increasingly crowded area with intense competition for ideas, talent and patient recruitment at key cancer centers. Sector risks include: development risk – uncertainty regarding the timing, efficacy, and market potential of new products and technologies; commercial risk – threats from

new/existing competition and pricing pressure; regulatory risk – timing/status of approvals and changes in labelling or new warnings on existing products and technologies; patent risk – products losing patent protection may face significant market share/price erosion and potential litigation; and currency risk – because of the mismatch between geographic location of cost base and sales. Valuation: We consider several methods when we set our price targets. We are most heavily influenced by DCF analysis. Our explicit forecasts run to 2025. From 2025, we assume 2% annual growth in (operating income x (1 – tax rate)) and a straight-line ROIC fade. ROIC fades to WACC over a 20 year period. This approach means that our DCF valuations are particularly sensitive to 2 parameters; WACC and our estimate of ROIC around 2025. Given these sensitivities, we sense-check our DCF valuation against PE multiples calculated on the basis of both adjusted ("core" or "non-GAAP" numbers) and IFRS or GAAP numbers, calibrated against the rest of the sector and considering the EPS growth profile. For our AstraZeneca DCF we use a WACC 5.6% and 2% terminal growth. 2025E ROIC is 9.2%. Our price target is 5,000p. This is 15.5x 2018E "core" and 27.2x 2018E IFRS earnings. Our sector "core" '18E target multiple is 14.2 but we see AZN as having good growth.

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| Highlights (US\$m) | 12/13 | 12/14 | 12/15 | 12/16E | 12/17E | 12/18E | 12/19E | 12/20E |
|---------------------------|---------|---------|---------|---------|---------|---------|----------|----------|
| Revenues | 25,711 | 26,547 | 24,708 | 23,031 | 21,588 | 22,298 | 23,927 | 26,689 |
| EBIT (UBS) | 8,390 | 6,937 | 6,902 | 6,799 | 6,499 | 6,554 | 7,296 | 8,564 |
| Net earnings (UBS) | 6,319 | 5,396 | 5,390 | 5,519 | 4,834 | 5,200 | 5,791 | 6,812 |
| EPS (UBS, diluted) (US\$) | 5.04 | 4.27 | 4.26 | 4.36 | 3.82 | 4.11 | 4.58 | 5.39 |
| DPS (US\$) | 2.80 | 2.80 | 2.80 | 2.80 | 2.80 | 2.54 | 2.75 | 2.51 |
| Net (debt) / cash | (1,159) | (4,483) | (8,813) | (9,743) | (9,491) | (9,911) | (10,253) | (11,169) |
| Profitability/valuation | 12/13 | 12/14 | 12/15 | 12/16E | 12/17E | 12/18E | 12/19E | 12/20E |
| EBIT margin % | 32.6 | 26.1 | 27.9 | 29.5 | 30.1 | 29.4 | 30.5 | 32.1 |
| ROIC (EBIT) % | 30.9 | 26.6 | 25.4 | 24.2 | 23.7 | 24.4 | 26.9 | 30.4 |
| EV/EBITDA (core) x | 6.2 | 9.3 | 9.7 | 7.7 | 8.1 | 8.1 | 7.5 | 6.8 |
| P/E (UBS, diluted) x | 10.0 | 16.5 | 15.8 | 11.8 | 13.5 | 12.5 | 11.3 | 9.6 |
| Equity FCF (UBS) yield % | 8.5 | 5.1 | 2.0 | 4.2 | 6.2 | 5.6 | 5.4 | 6.1 |
| Net dividend yield % | 5.5 | 4.0 | 4.2 | 5.4 | 5.4 | 4.9 | 5.3 | 4.9 |

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied.

Valuations: based on an average share price that year, (E): based on a share price of 4,055p on 02 Dec 2016 21:37 GMT

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| UBS 12-Month Rating | Rating Category | Coverage ¹ | IB Services ² |
|---------------------|-----------------|-----------------------|--------------------------|
| Buy | Buy | 45% | 36% |
| Neutral | Hold/Neutral | 45% | 36% |
| Sell | Sell | 11% | 19% |

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 March 2013.

| UBS 12-Month Rating | Definition |
|---------------------|---------------------------------------|
| Buy | FSR is > 6% above the MRA. |
| Neutral | FSR is between -6% and 6% of the MRA. |
| Sell | FSR is > 6% below the MRA. |

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Global Equity 12-Month Rating Definitions

Buy: FSR is > 6% above the MRA. **Neutral:** FSR is between -6% and 6% of the MRA. **Sell:** FSR is > 6% below the MRA.

Key Definitions

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

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