

# AstraZeneca

United Kingdom/Pharmaceuticals

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UBS Research

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## Less sceptical investors, less binary MYSTIC. Downgrade to Neutral. New 5,150p target price.

- Downgrading AstraZeneca to Neutral, raising our price target
- Our narrow technical view on MYSTIC not changed, but context has
- Normalized long-term operating margins: base case assumes 34%
- Valuation:

AstraZeneca was a stock where valuation implied unusually high scepticism with earnings forecasts, and where we sensed scepticism on the important MYSTIC trial of durvalumab/tremelimumab in lung cancer. Recent strong stock performance in the face of negative earnings revisions suggests markets are more comfortable, perhaps, with MYSTIC and the rest of the oncology portfolio (e.g., Tagrisso, Lynparza, non-lung IO).

### Our narrow technical view on MYSTIC not changed, but context has

We recently published a detailed analysis of the major news due in 2017 on immuno-oncology trials in lung cancer, of which MYSTIC is but one (click here). With this analysis, our focus shifted towards mature overall survival (OS) data. We won't see OS results from MYSTIC until 2018. Mid-2017 will yield results on the time it takes for patients' cancer to get worse (known as "PFS") but positive PFS data cannot mark AstraZeneca as a clear winner. Failure on PFS, however, could mark AstraZeneca as a likely loser. Therefore, our view of the 2017 risk / reward trade-off has changed although our view of MYSTIC in isolation has not.

### Normalized long-term operating margins: base case assumes 34%

AstraZeneca is generating supra-normal revenues by selling or doing other deals on some assets ("Externalisation Revenues" and "Other Operating Income") in order to support supra-normal investment in the pipeline and new drugs. This means near- and medium-term numbers are hard to forecast yet don't appear a good basis for valuation. We have looked again at Astra's peers to estimate a plausible margin, circa 2024-25, once things return to "normal". We continue to believe that a clean core operating margin in the 34% range (on ~\$32bn sales) is a reasonable base case. However, our new forecast assumes slower recovery to this margin level, hence lower EPS estimates.

### Valuation:

We focus on DCF in valuation, but sense-check vs. PE multiples for "core" and IFRS earnings, considering EPS growth profile. We also look at base, upside, and downside scenarios. Our DCF-derived target for AZN is 5,150p. This is 17.6x 2018e "core" and 42.6x 2018e IFRS earnings. Our sector "core" '18E target multiple is 14.3x. Astra's forecast growth is such that 2020 or 2021 P/E ratios are close to the sector multiple.

12-month rating	<b>Neutral</b>
Prior	Buy
12-month price target	<b>5,150.00p</b>
Prior	5,000p
Price	<b>4,955.00GBp</b>

Contributing authors: Marcus A. Koch

### Trading data and key metrics

52-wk range	5,220p-3,774
Market cap.	£62.7bn/US\$78.2bn
Shares o/s	1,265m (ORD)
Free float	99%
Avg. daily volume ('000)	2,854
Avg. daily value (m)	£130.8
Common s/h equity (12/17E)	US\$14.3bn
P/BV (12/17E)	5.5x
Net debt / EBITDA (12/17E)	1.1x
RIC	AZN.L
BBG	AZN LN

Sources: UBS, Bloomberg

### EPS (UBS, diluted) (US\$)

	From	To	% ch	Cons.
12/17E	3.82	3.66	-4	3.68
12/18E	4.10	3.65	-11	3.97
12/19E	4.57	4.11	-10	4.60

### 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](http://www.ubs.com/glossary)

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## Investment Thesis

### Investment Case

We have a Neutral rating on AstraZeneca. Valuation appears reasonable on a long-term DCF basis. We think that risks around immuno-oncology news, particularly PFS data from the MYSTIC trial in 2017, are evenly balanced.

### 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 2026. From 2026, 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 2026. 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. The ROIC and WACC parameters are shown in Figure 12. Our price target is 5,150p, which is very close the probability-weighted average of our base, upside case, and downside case scenarios. This is 17.6x 2018E "core" and 42.6x 2018E IFRS earnings. Our sector "core" '18E target multiple is 14.2x but we see AZN as having good growth. Our price target has increased slightly despite a decline in our out-year earnings estimates because we have become more confident in some of our oncology forecasts (e.g., durvalumab in bladder cancer, Lynparza, Tagrisso). This has reduced the effective discount rate compared with when we last set the price target.

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Highlights (US\$m)	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
Revenues	26,547	24,708	23,002	21,887	22,766	24,649	27,196	29,552
EBIT (UBS)	6,937	6,902	6,721	6,342	6,317	7,032	8,142	9,343
Net earnings (UBS)	5,396	5,390	5,455	4,629	4,624	5,201	6,094	7,066
EPS (UBS, diluted) (US\$)	4.27	4.26	4.31	3.66	3.65	4.11	4.81	5.58
DPS (US\$)	2.80	2.80	2.80	1.61	1.81	1.87	2.63	3.35
Net (debt) / cash	(4,483)	(8,813)	(11,790)	(11,641)	(11,185)	(11,114)	(11,542)	(12,246)
Profitability/valuation	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
EBIT margin %	26.1	27.9	29.2	29.0	27.7	28.5	29.9	31.6
ROIC (EBIT) %	26.6	25.4	23.3	21.8	22.3	25.1	28.5	31.6
EV/EBITDA (core) x	9.3	9.7	9.7	9.2	9.4	8.8	8.1	7.4
P/E (UBS, diluted) x	16.5	15.8	13.8	16.9	16.9	15.0	12.8	11.1
Equity FCF (UBS) yield %	5.1	2.0	4.5	4.9	5.7	5.3	6.0	6.9
Net dividend yield %	4.0	4.2	4.7	2.6	2.9	3.0	4.3	5.4

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 4,955p on 04 Apr 2017 17:30 BST

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UBS 12-Month Rating	Rating Category	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	Buy	45%	29%
Neutral	Hold/Neutral	39%	27%
Sell	Sell	15%	16%

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 December 2016.

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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#### Company Disclosures

Company Name	Reuters	12-mo rating	Price	Price date
AstraZeneca	AZN LN	Buy	4,955p	04 Apr 2017

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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## Global rating history -- AstraZeneca, AZN LN



Source: UBS CIO as of 5 April 2017

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Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1H, 2H, etc. or 1H11, 2H11, etc.	First half, second half, etc. or first half 2011, second half 2011, etc.	1Q, 2Q, etc. or 1Q11, 2Q11, etc.	First quarter, second quarter, etc. or first quarter 2011, second quarter 2011, etc.
2011E, 2012E, etc.	2011 estimate, 2012 estimate, etc.	A	actual i.e. 2010A
ADR	American depository receipt	ARPU	Average Revenue Per User
AUM	Assets under management = total value of own and third-party assets managed	Avg.	average
bn	Billion	bp or bps	Basis point or basis points (100 bps = 1 percentage point)
BVPS	Book value per share = shareholders' equity divided by the number of shares	CAGR	Compound annual growth rate
Cant Inc/Capita	Cantonal income per capita (Switzerland only)	Capex	Capital expenditures
CF	Cash flow	CFO	1) Cash flow from operations, 2) Chief financial officer
COGS	Cost of goods sold	COM	Common shares
Cons.	Consensus	Core Tier 1 Ratio	Tier 1 capital minus tier 1 hybrid securities
Cost/Inc Ratio (%)	Costs as a percentage of income	CPI	Consumer price index
CR	Combined ratio = ratio of claims and expenses as a percentage of premiums (for insurance companies)	CY	Calendar year
DCF	Discounted cash flow	DDM	Dividend discount model
Dividend Yield (%)	Dividend per share divided by price per share	DPS	Dividend per share
E	expected i.e. 2011E	EBIT	Earnings before interest and taxes
EBIT Margin (%)	EBIT divided by revenues	EBITDA	Earnings before interest, taxes, depreciation and amortization
EBITDA Margin (%)	EBITDA divided by revenues	EBITDA/Net Interest	EBITDA divided by net interest expense
EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental expense	EFVR	Estimated fair value range
EmV	Embedded value = net asset value + present value of forecasted future profits (for life insurers)	EPS	Earnings per share
Equity Ratio (%)	Shareholders' equity divided by total assets	EV	Enterprise value = market value of equity, preferred equity, outstanding net debt and minorities
FCF	Free cash flow = cash a company generates above outlays required to maintain/expand its asset base	FCF Yield (%)	Free cash flow divided by market capitalization
FFO	Funds from operations	FY	Fiscal year / financial year
GDP	Gross domestic product	Gross Margin (%)	Gross profit divided by revenues
H	half year	h/h	Half-year over half-year; half on half
hist av.	Historical average	Interbank Ratio	Interbank deposits due from banks divided by interbank deposits due to banks
Interest Coverage	Ratio that expresses the number of times interest expenses are covered by earnings	Interest exp	Interest expense
ISIN	International securities identification number	K	One thousand
LLP/Net Int Inc (%)	Loan loss provisions divided by net interest income	LLR/Gross Loans (%)	Loan loss reserves divided by gross loans

# AstraZeneca

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
LPR	Least Preferred: The stock is expected to both underperform the relevant benchmark and depreciate in absolute terms.	Market cap	Number of all shares of a company (at the end of the quarter) times closing price
m/m	Month-over-month; month on month	mn or m	Million
M and A	Merger and Acquisition	MP	Marketperform: The stocks expected performance is in line with the sector benchmark
MPR	Most Preferred: The stock is expected to both outperform the relevant benchmark and appreciate in absolute terms.	n.a.	Not available or not applicable
NAV	Net asset value	Net Debt	Short- and long-term interest-bearing debt minus cash and cash equivalents
Net DPS	Net dividends per share	NIM or Net Int Margin (%)	Net interest income divided by average interest-bearing assets
Net Margin (%)	Net income dividend by revenues	NV	Neutral View: The stock is expected to neither outperform nor underperform the relevant benchmark nor significantly appreciate or depreciate in absolute terms.
n.m. or NM	Not meaningful	NPL	Non-performing loans
OP	Outperform: The stocks is expected to outperform the sector benchmark	Op Margin (%)	Operating income divided by revenues
p.a.	Per annum (per year)	P/BV	Price to book value
P/E or PE	Price to earnings / Price Earnings Ratio	P/E Relative	P/E relative to the market
P/EmV	Price to embedded value	PEG Ratio	P/E ratio divided by earnings growth
PPI	Producer price index	Prim Bal/Cur Rev (%)	Primary balance divided by current revenue (total revenue minus capital revenue)
Profit Margin (%)	Net income divided by revenues	q/q or QQQ	Quarter-over-quarter; quarter on quarter
R and D	Research and development	ROA (%)	Return on assets
ROAE (%)	Return on average equity	ROCE (%)	Return on capital employed = EBIT divided by difference between total assets & current liabilities
ROE (%)	Return on equity	ROIC (%) or ROI	Return on invested capital
Shares o/s	Shares outstanding	Solvency Ratio (%)	Ratio of shareholders' equity to net premiums written (for insurance companies)
sotp or SOTP	Sum of the parts	Tax Burden Index	Swiss tax index; 100 = average tax burden of all cantons
tgt	Target	Tier 1 Ratio (%)	Tier 1 capital divided by risk-weighted assets; describes a bank's capital adequacy
tn	Trillion	UP	Underperform: The stock is expected to underperform the sector benchmark
Valor	Swiss company identifier	WACC	Weighted average cost of capital
CIO	UBS WM Chief Investment Office	x	multiple / multiplier
y/y or YOY	Year-over-year; year on year	yr	Year
YTD	Year-to-date		

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