

Novartis

Switzerland/Pharmaceuticals

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UBS Research

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Division Perimeter Restatements reveal low Alcon Profitability excl. Ophthalmic Pharma

- Alcon Core Op. Margin ex Ophthalmic Pharma was 20.6% in 2015
- Ophthalmic Pharma had a core operating margin of 47.9% in 2015
- Sandoz benefits by a 220 bps margin uplift from Pharma products
- Valuation: Buy PT CHF100, based on 17x 2017E Core EPS

Alcon Core Op. Margin ex Ophthalmic Pharma was 20.6% in 2015

This morning, Novartis released 2015 restated numbers for the perimeter changes of its 3 divisions, announced with FY'15 results (Ophthalmic Pharma is transferred from Alcon to Pharma whereas 19 mature products are transferred from Pharma to Sandoz). Most importantly, the restatements reveal the profitability of 'rump-Alcon' (Surgical and Consumer) excluding the contribution of Ophthalmic Pharma at 20.6% for 2015. Novartis stated in this morning's slides pack that this profitability is in line with the medical device sector. However, in the vision sector this looks relatively low. For comparison, the Cooper Companies reported a non-GAAP operating margin of 23.5% and 23.1% for 2014 & 2015, despite having a greater contribution from Contact lenses/Consumer (82% vs 38% for 'rump Alcon'), which we believe has lower margins than the Surgical business.

Ophthalmic Pharma had a core operating margin of 47.9% in 2015

In view of several years of large price increases taken in the US (Fig 2) in recent years, the 47.9% core op margin of ophthalmic Pharma is perhaps not surprising. Key issue is how the sustainable this US\$1.8bn core op profit contribution will be in view of generic erosions in glaucoma and allergy. Keeping the Pharma margin steady in 2016 in view of the Glivec and the Alcon Pharma erosion remain challenging for Novartis.

Sandoz benefits by a 220 bps margin uplift from Pharma products

Sandoz benefits from the transfer of US\$913m Pharma mature product sales that come at a 42% core op margin which lifts the Sandoz core op margin by 220 bps. Novartis is due to host a conference call this afternoon to discuss the restatements at 14:00 CEST – tel: +44 20 3003 2666, confirmation code = Novartis.

Valuation: Buy PT CHF100, based on 17x 2017E Core EPS

Our PT is underpinned by SOTP/ NPV analysis that yields a fair value of CHF100/ share.

12-month rating	Buy
12-month price target	CHF100.00
Price	CHF70.05

Trading data and key metrics

52-wk range	CHF102.30-69.55
Market cap.	CHF171bn/US\$178bn
Shares o/s	2,447m (REG.)
Free float	82%
Avg. daily volume ('000)	8,042
Avg. daily value (m)	CHF606.6
Common s/h equity (12/15E)	US\$73.5bn
P/BV (12/15E)	2.3x
Net debt / EBITDA (12/15E)	0.6x
RIC	NOVN.VX
BBG	NOVN.VX

Sources: UBS, Bloomberg

EPS (UBS, diluted) (US\$)

	UBS	Cons.
12/15E	5.02	4.83
12/16E	5.10	4.96
12/17E	5.61	5.45

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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Novartis

Company Profile: Novartis

Novartis is a leading European large-cap diversified pharmaceutical company. Following the GSK asset swap (closed in March 2015), it has three divisions: Pharmaceuticals (64% of 2014 core operating profit; growth drivers: Tasigna, Gilenya, Xolair, Cosentyx, Entresto), Alcon (26%, a leading eye-care business selling cataract surgical equipment, ophthalmic drugs and contact lenses) and Sandoz (11%, focused on high-value generics including biosimilars). Novartis holds also a 36.5% stake in GSK's consumer business and 33% of Roche's bearer shares.

Statement of Risk

Risks to our thesis on Novartis include: (1) lower uptake of Entresto for heart failure and Cosentyx for psoriasis than we model, resulting in lower sales growth and less margin expansion.(2) an uncertain outlook for Alcon wher recovery may take longer thna widely expected. Risks for the pharmaceutical industry include political risks, government oversight of the approval and ongoing manufacturing process, discovery bottleneck and pipeline attrition, competitive development, patent challenges and product liability.Our 100 PT is based on 17x 2017 CoreEPS multiple and supported by NPV/SOTP valuation.

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Highlights (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	57,505	58,831	58,974	50,534	50,278	52,730	56,930	60,364
EBIT (UBS)	14,780	14,485	14,616	14,023	13,937	15,230	17,553	19,452
Net earnings (UBS)	12,381	12,416	12,685	12,294	12,375	13,626	15,677	17,393
EPS (UBS, diluted) (US\$)	5.07	5.01	5.14	5.02	5.10	5.61	6.46	7.17
DPS (CHF)	2.30	2.45	2.60	2.75	2.90	3.10	3.40	3.80
Net (debt) / cash	(11,607)	(8,796)	(6,549)	(10,589)	(11,223)	(6,688)	(1,139)	5,822
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	25.7	24.6	24.8	27.7	27.7	28.9	30.8	32.2
ROIC (EBIT) %	20.9	20.3	21.1	20.0	19.3	22.1	26.8	31.3
EV/EBITDA (core) x	7.8	9.6	11.9	9.8	9.8	9.0	7.9	7.0
P/E (UBS, diluted) x	11.4	14.6	17.2	13.9	14.3	12.9	11.3	10.1
Equity FCF (UBS) yield %	8.2	5.5	4.7	12.2	4.7	7.1	7.9	9.1
Net dividend yield %	4.3	3.6	3.2	3.9	4.1	4.4	4.9	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 CHF70.05 on 30 Mar 2016 21:35 BST

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	47%	33%
Neutral	Hold/Neutral	42%	34%
Sell	Sell	11%	23%

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 2014.

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).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

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Company Disclosures

Novartis	NOVN VX	Buy	CHF70.05	30 Mar 2016
Company Name	Reuters	12-mo rating	Price	Price date

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

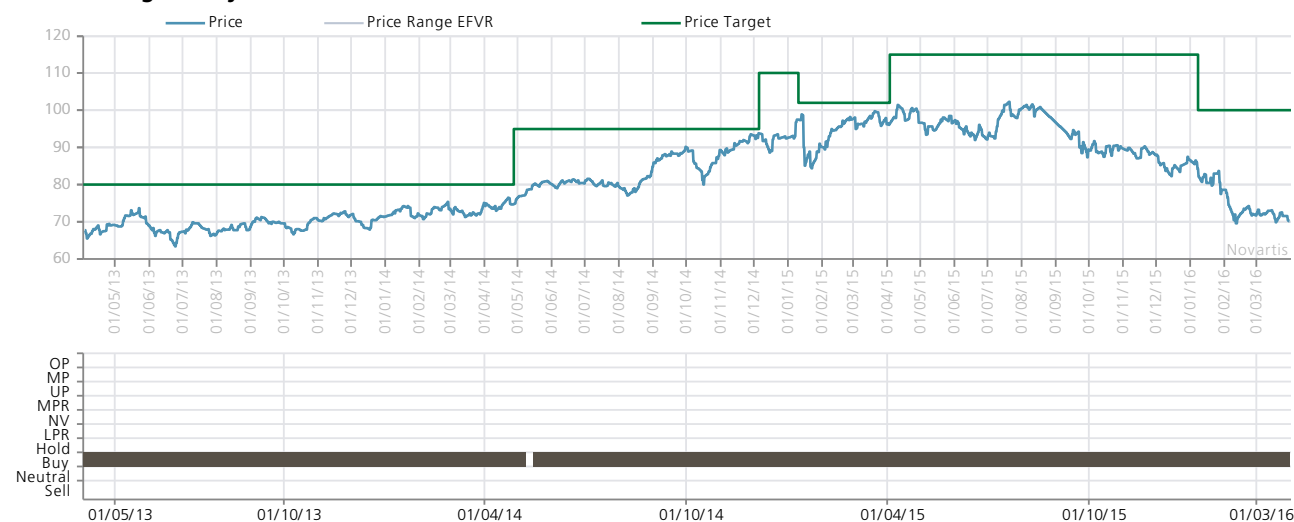
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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Global rating history -- Novartis, NOVN VX



Source: UBS CIO as of 31 March 2016

Terms and Abbreviations

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 depositary 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

Novartis

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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