

# Novartis

Switzerland/Pharmaceuticals

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UBS Research

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## 2Q16 Core EPS 2% beat but Alcon op. inc. weak; Entresto promotion lowers FY16 op. inc. guidance

- 2Q16: Core EPS beat cons. by 2.2% & in line with UBSe; Alcon op. inc. weak
- FY16 Core op. inc. guidance lowered due to higher 2H16 Entresto promotion
- 3% Pharma sales beat due to Cosentyx, Diovan, Glivec; Alcon op. inc. weak
- Valuation: Neutral, PT CHF72

### 2Q16: Core EPS beat cons. by 2.2% & in line with UBSe; Alcon op. inc. weak

Novartis reported Core EPS (cont ops) of \$1.23: in line with UBSe of \$1.23 and 2.2% above consensus of \$1.20 (FOA consensus, 4 July 2016). Core operating income (cont ops) was \$3,332m: in line with UBSe of \$3,334m and 2.5% above cons of \$3,250m. Although Pharma core op. inc. beat cons. by 4%, Alcon core op. inc. was 14% below cons. Group sales of \$12,470m was in line with UBSe of \$12,474m and beat cons. of \$12,225m by 2%.

### FY16 Core op. inc. guidance lowered due to higher 2H16 Entresto promotion

Novartis has lowered Group FY16 core operating income guidance. Previously, core op. inc. was expected to be broadly in line with FY15 (CC) – revised guidance is for op inc. to be broadly in line or decline at low single digit (CC), on the back of increased Entresto spending and depending on Gleevec erosion. Higher Entresto spending will be targeted towards building a U.S. primary care sales field force and investing in incremental medical support. FY16 Sales guidance remains unchanged, with Group Net Sales expected to be broadly in line with the prior year (CC).

### 3% Pharma sales beat due to Cosentyx, Diovan, Glivec; Alcon op. inc. weak

Pharma sales of \$8,387m (-1% CC) were 0.5% above UBSe of \$8,345m and 2.7% above cons. of \$8,164m. Pharma Core op. inc. was \$2,669m (3.9% above cons. of \$2,569m). On a product level, there were big beats vs. cons. on Cosentyx (+28%), Diovan (+12% vs. cons.) and Glivec (+20% vs. cons.), although Exjade (-6% vs. cons.) and Afinitor (-8%) were lower than cons. and Entresto sales of \$32m were below both UBSe (\$35m) and cons. (\$36m). Alcon sales of \$1,506m were 2.1% below UBSe of \$1,538m and 0.7% above cons. of \$1,495m. However, core op. inc. was \$238m (14% below cons. of \$278m). Sandoz sales of \$2,577m were 0.5% below UBSe of \$2,591m were in line with cons. of \$2,567m. Core op. inc. was \$535m (in line with cons. of \$536m).

### Valuation: Neutral, PT CHF72

Our PT is based on 14x '17E Core EPS: broadly in line with the current sector multiple of 14.8x (excl. Novo).

12-month rating	<b>Neutral</b>
12-month price target	<b>CHF72.00</b>
Price	<b>CHF80.45</b>

### Trading data and key metrics

52-wk range	CHF102.30-68.50
Market cap.	CHF193bn/US\$197bn
Shares o/s	2,403m (REG.)
Free float	82%
Avg. daily volume ('000)	5,609
Avg. daily value (m)	CHF427.9
Common s/h equity (12/16E)	US\$73.8bn
P/BV (12/16E)	2.7x
Net debt / EBITDA (12/16E)	1.0x
RIC	NOVN.VX
BBG	NOVN.VX

Sources: UBS, Bloomberg

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

	UBS	Cons.
12/16E	4.80	4.76
12/17E	5.07	5.19
12/18E	5.71	5.80

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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# 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 where recovery may take longer than 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. Valuation: Neutral, PT CHF72. Our PT is based on 14x '17E Core EPS: broadly in line with the current sector multiple of 14.8x (excl. Novo).

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Highlights (US\$m)	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
Revenues	58,831	58,974	50,359	50,287	51,651	54,804	57,480	59,647
EBIT (UBS)	14,485	14,616	13,790	13,262	13,732	15,410	16,959	18,226
Net earnings (UBS)	12,416	12,685	12,030	11,704	12,371	13,910	15,380	16,615
EPS (UBS, diluted) (US\$)	5.01	5.14	4.93	4.80	5.07	5.71	6.31	6.82
DPS (CHF)	2.45	2.60	2.70	2.80	3.10	3.40	3.80	4.20
Net (debt) / cash	(8,796)	(6,549)	(16,484)	(17,763)	(14,313)	(10,679)	(5,771)	(604)
Profitability/valuation	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
EBIT margin %	24.6	24.8	27.4	26.4	26.6	28.1	29.5	30.6
ROIC (EBIT) %	20.3	21.1	19.4	17.9	19.2	22.7	26.4	30.0
EV/EBITDA (core) x	9.6	11.9	12.4	11.1	10.7	9.7	8.8	8.1
P/E (UBS, diluted) x	14.6	17.2	19.7	17.0	16.1	14.3	13.0	12.0
Equity FCF (UBS) yield %	5.5	4.7	4.0	3.8	5.8	6.3	7.3	8.0
Net dividend yield %	3.6	3.2	2.9	3.5	3.9	4.2	4.7	5.2

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 CHF80.45 on 18 Jul 2016 21:35 BST

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UBS 12-Month Rating	Rating Category	Coverage <sup>1</sup>	IB Services <sup>2</sup>
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.

### UBS Investment Research: Global Equity Ratings Definitions

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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.

### Exceptions and Special Cases

**Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified the Companies Mentioned or Company Disclosure table in the relevant research piece.

### Company Disclosures

Novartis	NOVN VX	Neutral	CHF80.45	18 Jul 2016
AstraZeneca	AZN LN	Buy	4,527p	18 Jul 2016
Roche	ROG VX	Buy	CHF253.20	18 Jul 2016
GlaxoSmithKline	GSK LN	Neutral	1,652p	18 Jul 2016
Sanofi	SAN FP	Neutral	€75.17	18 Jul 2016
Novo Nordisk	NOVOB DC	Sell	DKr372.20	18 Jul 2016
Bayer	BAYN GR	Neutral	€92.70	18 Jul 2016

Company Name	Reuters	12-mo rating	Price	Price date
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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

### Disclosures (19 July 2016)

AstraZeneca 4, 9, 10, 11, GlaxoSmithKline 2, 4, 9, Novartis 1, 2, 3, 4, 5, 6, 7, 8, 9, Novo Nordisk 4, 12; Roche 2, 3, 5, 6, 7, 9, Sanofi 4, 9, 1. UBS AG, its affiliates or subsidiaries beneficially owned 1% or more of a class of this company's common equity securities as of last month's end (or the prior month's end if this report is dated less than 10 days after the most recent month's end).

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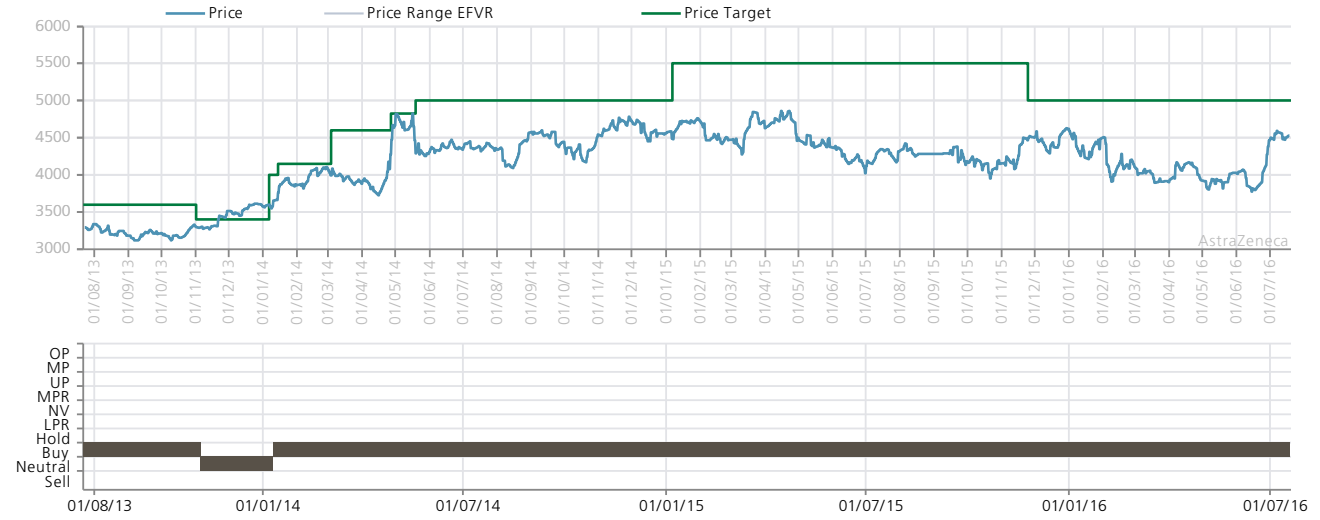
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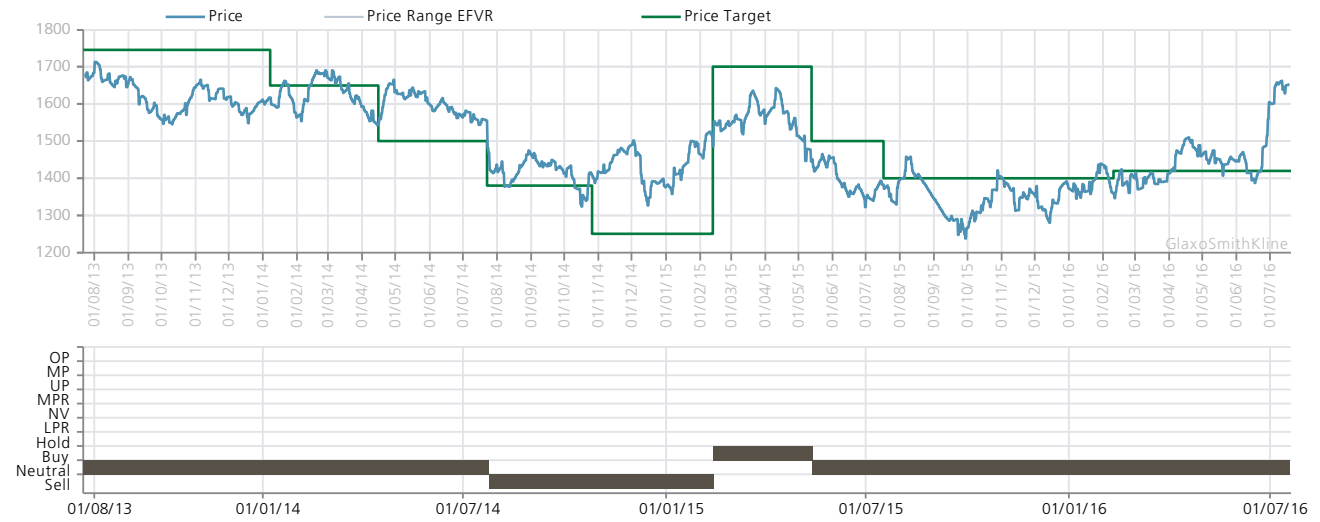
12. A U.S.-based global equity strategist, a member of his team, or one of their household members has a long common stock position in Novo Nordisk A/S.

## Global rating history -- AstraZeneca, AZN LN



Source: UBS CIO as of 19 July 2016

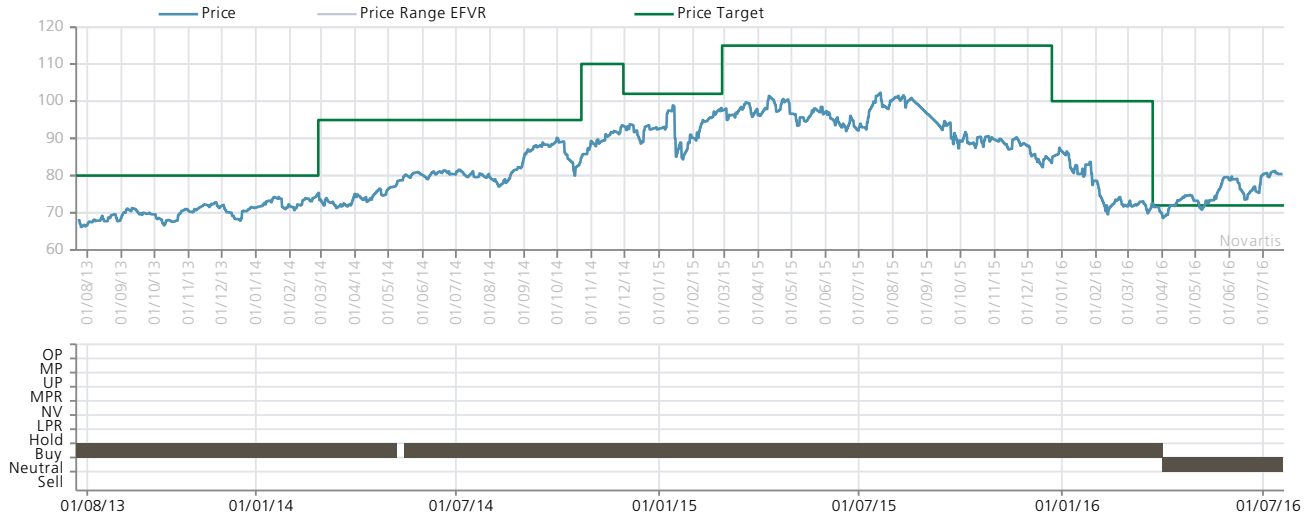
## Global rating history -- GlaxoSmithKline, GSK LN



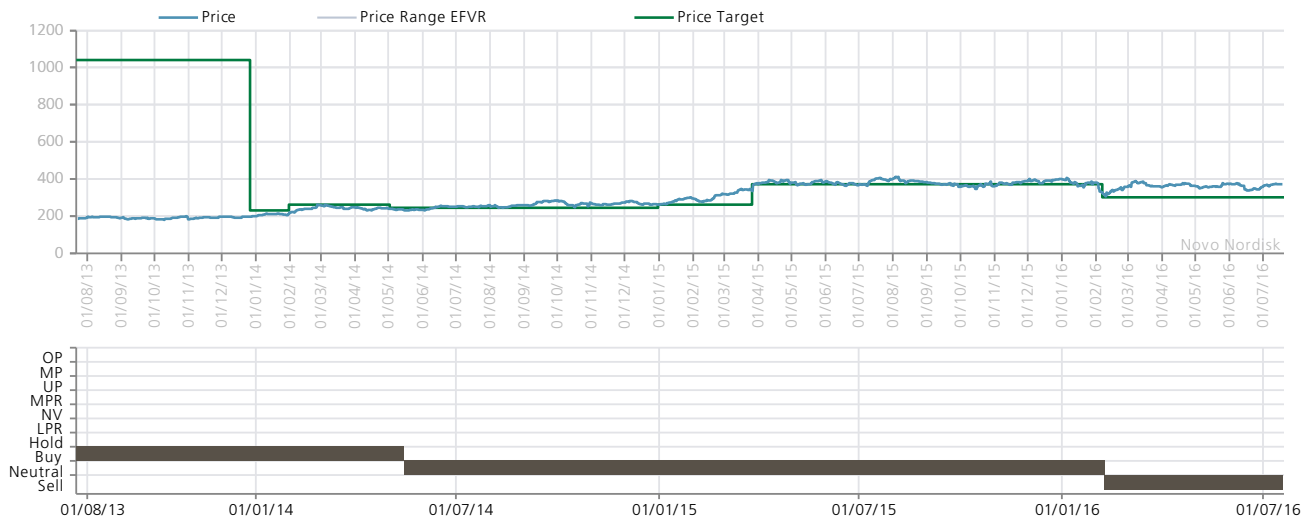
Source: UBS CIO as of 19 July 2016

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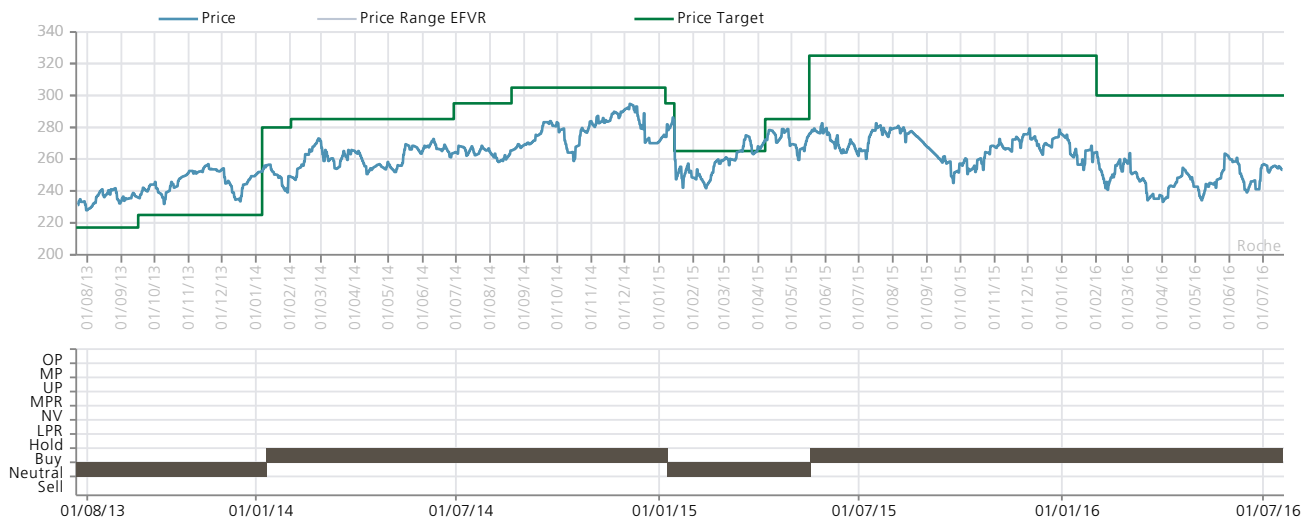
## Global rating history -- Novartis, NOVN VX



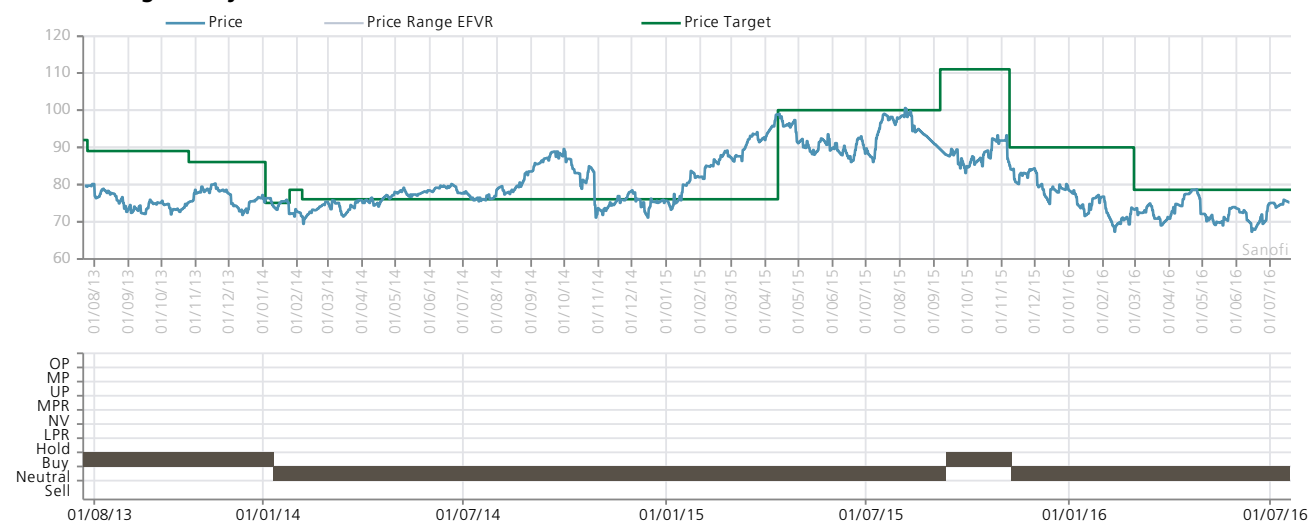
## Global rating history -- Novo Nordisk, NOVOB DC



## Global rating history -- Roche, ROG VX



## Global rating history -- Sanofi, SAN FP



Source: UBS CIO as of 19 July 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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