

Novartis

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UBS Evidence Lab: Spotlight on Alcon data points as pharma continues to struggle

- UBS Evidence Lab 1: Not dropping the Ball
- UBS Evidence Lab 2: Top dog with quality, so why a sheep on contact pricing?
- Corporate actions still a likely way forward
- Valuation:

There has been an improvement in the overall satisfaction score at Novartis' (eye-care business) Alcon since our last Glassdoor analysis. The improvement in senior management approval is in-line with the peer group but what stands out is that CEO approval, once a laggard, has now exceeded its peers. Combine this with an above-average score for "Business Outlook" and it implies that Alcon's change in management and approach (from cost cutting to targeted investment) is a positive indication for Alcon recovery and possibly the eye care market overall.

UBS Evidence Lab 2: Top dog with quality, so why a sheep on contact pricing?

Following the introduction of J&J's Oasys contact lens we have analysed >30,000 contact lens price data points to determine whether Alcon has a pricing strategy in step with that of a market leader. Our analysis still demonstrates that Alcon is not the price setter in the contact lens space. The good news is that pricing headwinds seems to be temporarily over and that there could be upside to pricing as prices converge between products that are not like for like (i.e. Cooper's MyDay & Alcon's Dailies Total-1 vs J&J's Oasys).

Corporate actions still a likely way forward

We rate Novartis Neutral as we believe: i) the pharma business will struggle to grow its top-line (heart failure drug, Entresto is unlikely to meet even reduced expectations - consensus \$4.0bn/UBSe \$2.2bn), and ii) that whilst our work with UBS Evidence Lab points towards a recovery, questions remained as to how long management and investors have the patience to wait and see. We believe the ongoing headwinds may prompt M&A (size to be determined) and this might then come with portfolio changes that dilute earnings to the tune of ~15% (Link). The low valuation indicates that the market subscribes to this outlook but in order to be constructive the top-line needs to move.

Valuation:

We value Novartis on DCF basis (WACC 6.3%, 2% terminal growth, ROIC fading to WACC over medium term). This yields our price target of CHF70. This is 14.4x '17e "core" earnings vs our 14.2x sector "core" '17e target multiple.

12-month rating	Neutral
12-month price target	CHF70.00
Price	CHF74.60

Contributing authors: Marcus A. Koch

Trading data and key metrics

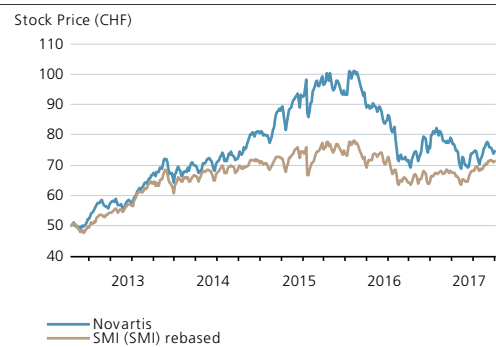
52-wk range	CHF82.50-68.15
Market cap.	CHF177bn/US\$177bn
Shares o/s	2,378m (REG.)
Free float	82%
Avg. daily volume ('000)	6,711
Avg. daily value (m)	CHF499.7
Common s/h equity (12/17E)	US\$69.0bn
P/BV (12/17E)	2.5x
Net debt / EBITDA (12/17E)	1.1x
RIC	NOVN.VX
BBG	NOVN VX

Sources: UBS, Bloomberg

EPS (UBS, diluted) (US\$)

	UBS	Cons.
12/17E	4.78	4.71
12/18E	5.34	5.22
12/19E	5.57	5.67

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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Analyst certification and required disclosures begin on page 3

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Investment Thesis

Investment Case

The structural challenges of patent expiries and an elusive Alcon recovery continue. We think the market had hoped for sector-beating earnings momentum in '17, which in our view, the company is not positioned to deliver. As Novartis doesn't seem to have the answer to weak Entresto (heart failure) launch, an acquisition in pharma appears increasingly likely in our view, and we could see asset sales to fund said M&A in line with recent press reports (e.g. the FT). No action leaves the stock trading in-line with the sector for sub-par EPS growth (5%), asset disposals suggest a 20% premium to the sector demanding significant earnings accretion. We remain on the sidelines.

Company Profile: Novartis

Novartis is a Swiss large-cap diversified pharmaceutical company. Following the GSK asset swap (closed in March 2015), it has four divisions: Innovative Medicines (79% of 2015 core operating profit; main therapy areas: oncology, ophthalmology, neuroscience, immunology, respiratory and cardio-metabolic), Alcon (9%, a leading eye-care business selling cataract surgical equipment and contact lenses), Sandoz (15%, focused on high-value generics, including biosimilars) and Corporate (loss-making). Novartis also has a 36.5% stake in the consumer healthcare joint venture with GSK as well as 33% of Roche's bearer shares.

Statement of Risk

Risks to our thesis on Novartis include: (1) better uptake of Entresto for heart failure and (2) lower uptake for Cosentyx in psoriasis than we model which would result in different sales and

margin expansion; (3) a fast recovery for Alcon which would drive better earnings momentum than we currently model. 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: 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..

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Highlights (US\$m)	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
Revenues	53,332	50,359	49,386	49,339	51,699	53,025	53,443	55,471
EBIT (UBS)	14,473	13,790	12,987	12,633	13,917	14,347	14,079	14,835
Net earnings (UBS)	12,685	11,774	11,328	11,094	12,293	12,704	12,657	13,395
EPS (UBS, diluted) (US\$)	5.14	4.83	4.72	4.78	5.34	5.57	5.60	5.98
DPS (CHF)	2.60	2.70	2.75	2.81	2.91	3.00	3.11	3.21
Net (debt) / cash	(6,549)	(16,484)	(16,025)	(19,125)	(16,623)	(14,703)	(13,137)	(11,216)
Profitability/valuation	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
EBIT margin %	27.1	27.4	26.3	25.6	26.9	27.1	26.3	26.7
ROIC (EBIT) %	20.7	19.3	17.3	17.3	19.7	20.8	20.9	22.4
EV/EBITDA (core) x	11.2	12.3	9.8	10.1	9.5	9.2	9.3	8.9
P/E (UBS, diluted) x	17.2	20.2	16.3	15.6	13.9	13.4	13.3	12.5
Equity FCF (UBS) yield %	4.7	3.4	5.5	5.4	5.6	5.4	5.4	5.7
Net dividend yield %	3.2	2.9	3.6	3.8	3.9	4.0	4.2	4.3

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 CHF74.60 on 05 Apr 2017 18:30 BST

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UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
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).

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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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

Company Name	Reuters	12-mo rating	Price	Price date
Novartis	NOVN VX	Neutral	CHF74.75	04 Apr 2017
AstraZeneca	AZN LN	Neutral	4,955p	04 Apr 2017
Roche	ROG VX	Buy	CHF257.00	04 Apr 2017
GlaxoSmithKline	GSK LN	Neutral	1,661p	04 Apr 2017
Sanofi	SAN FP	Neutral	€85.30	04 Apr 2017
Novo Nordisk	NOVOB DC	Buy	DKr250.70	04 Apr 2017
Bayer	BAYN GR	Buy	€107.64	04 Apr 2017
Pfizer	PFE US	Buy	US\$34.34	04 Apr 2017
Lilly	LLY US	Neutral	US\$86.09	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

Disclosures (6 April 2017)

AstraZeneca 4, 11, 13, 14, GlaxoSmithKline 4, 11, 12, Lilly (Eli) & Co. 4, 8, 9, 11, 12, 13, 14, 15, Novartis 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, Novo Nordisk 4, 16, Pfizer Inc. 4, 8, 11, 13, 14, 17, 18; Roche 2, 6, 7, 8, 9, 11, 12, Sanofi 4, 11,

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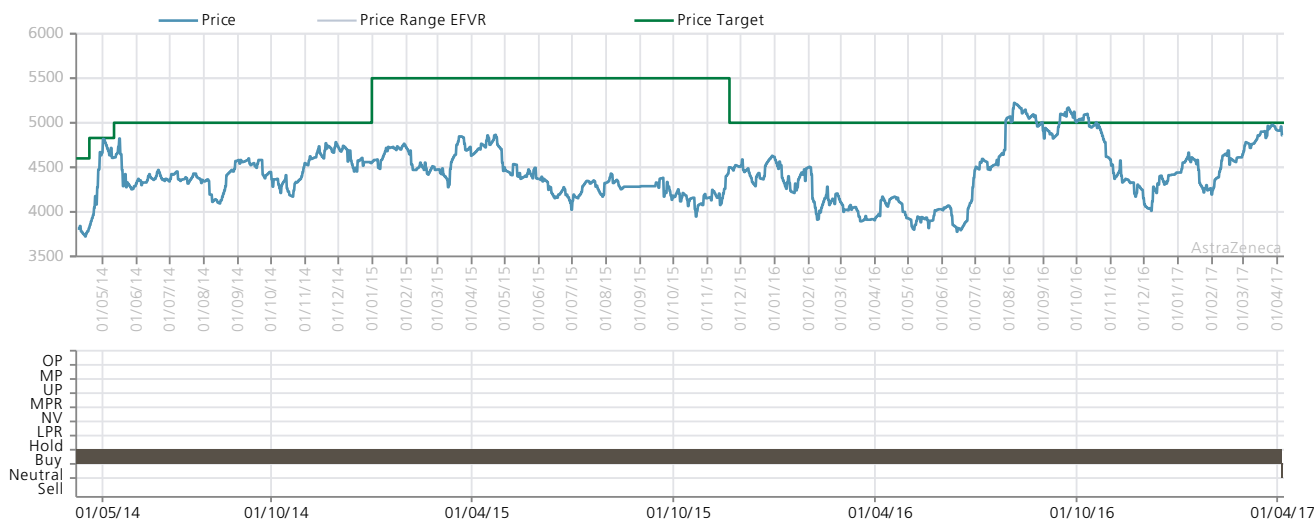
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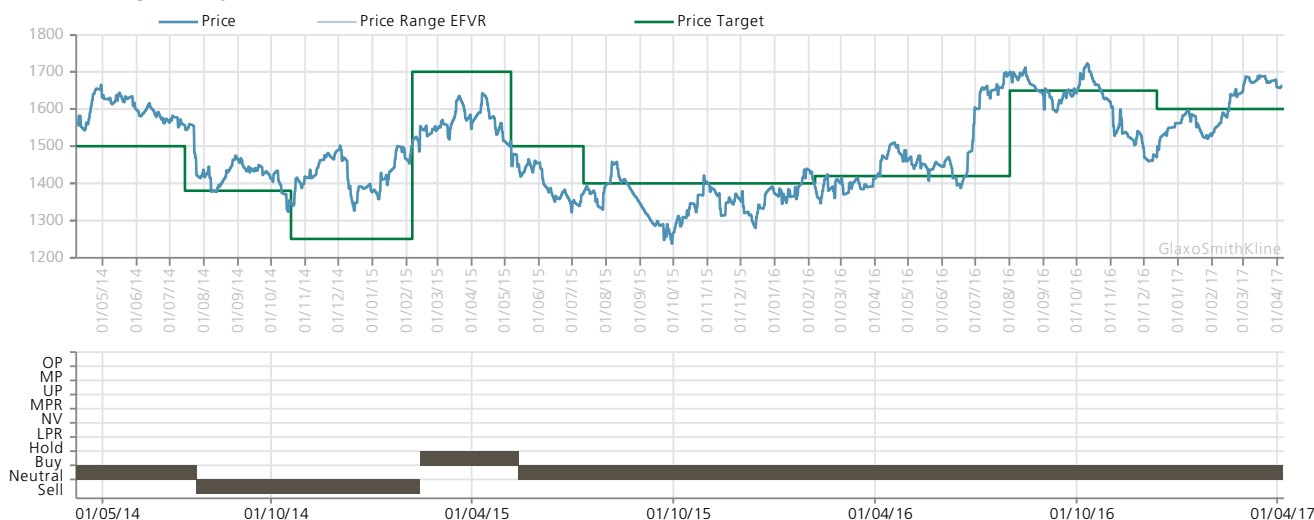
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Global rating history -- AstraZeneca, AZN LN



Source: UBS CIO as of 6 April 2017

Global rating history -- GlaxoSmithKline, GSK LN



Source: UBS CIO as of 6 April 2017

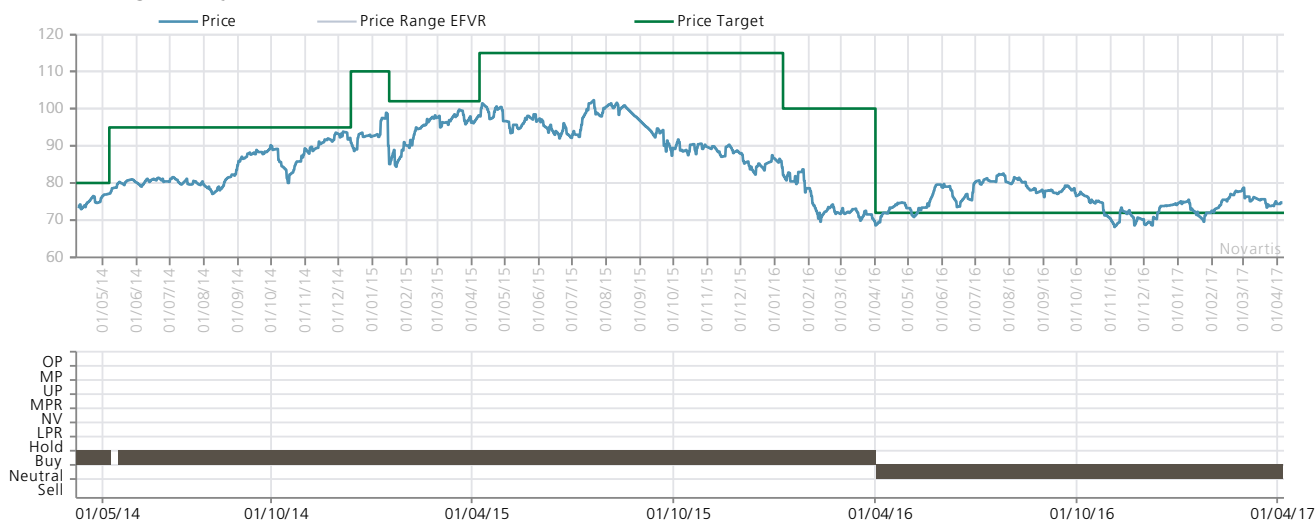
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Global rating history -- Lilly (Eli) & Co., LLY US



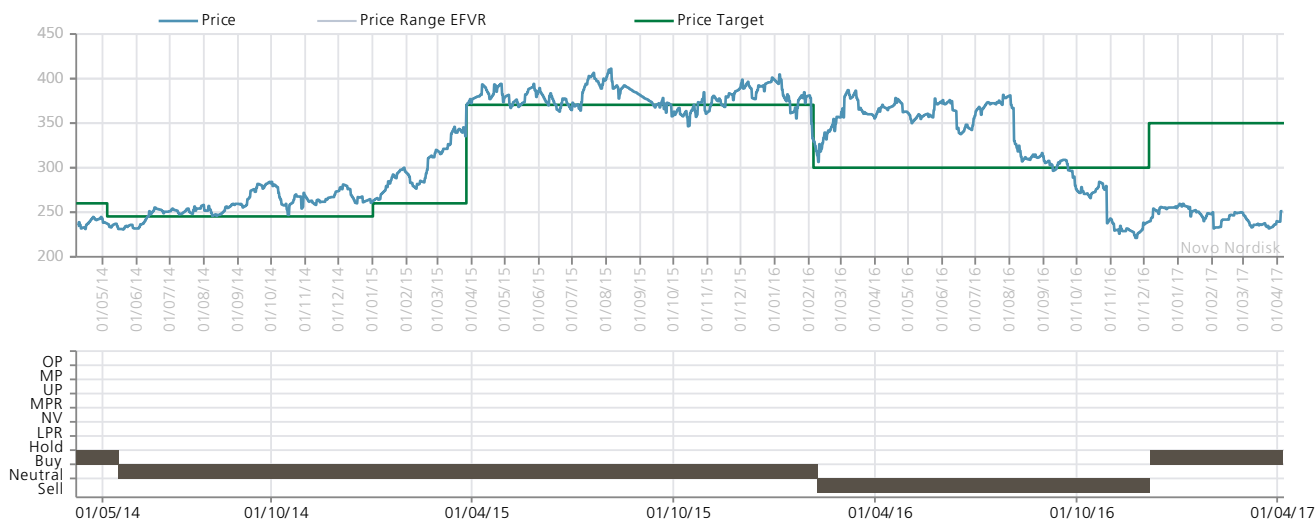
Source: UBS CIO as of 6 April 2017

Global rating history -- Novartis, NOVN VX



Source: UBS CIO as of 6 April 2017

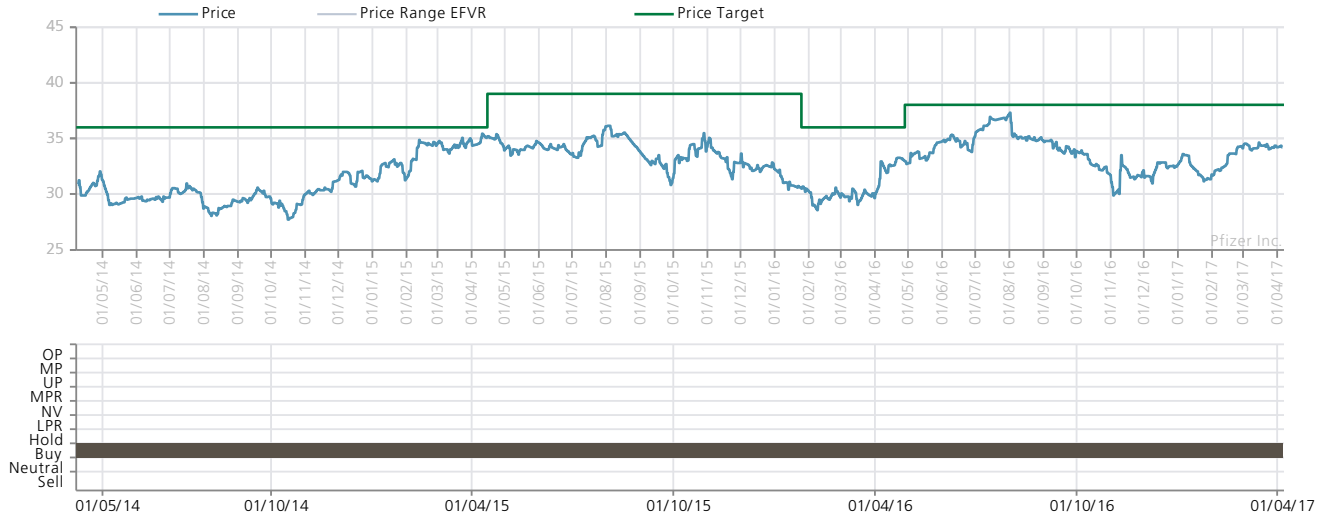
Global rating history -- Novo Nordisk, NOVOB DC



Source: UBS CIO as of 6 April 2017

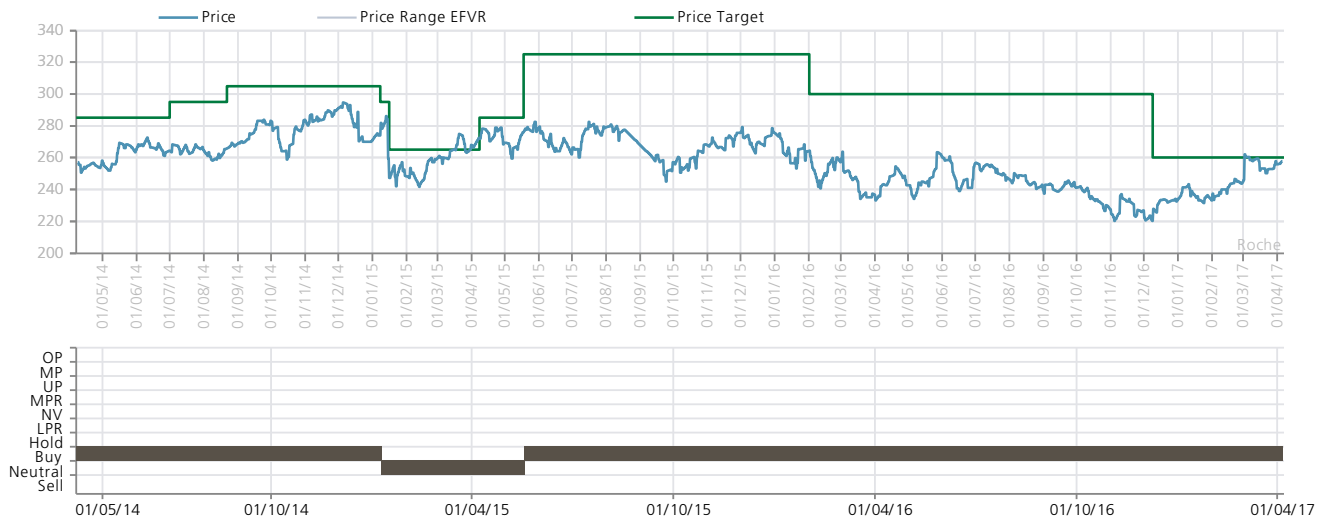
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Global rating history -- Pfizer Inc., PFE US



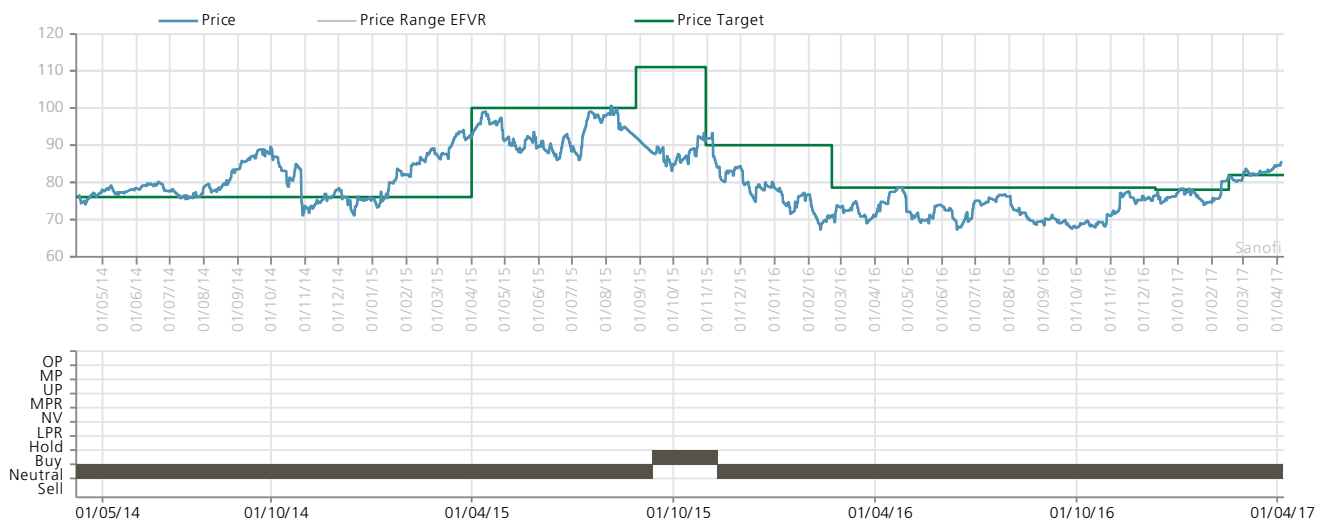
Source: UBS CIO as of 6 April 2017

Global rating history -- Roche, ROG VX



Source: UBS CIO as of 6 April 2017

Global rating history -- Sanofi, SAN FP



Source: UBS CIO as of 6 April 2017

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
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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 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 expected i.e. 2011E	DPS	Dividend per share
E		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
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

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Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
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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