UBS

Roche

Switzerland/Pharmaceuticals
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UBS Research
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12-month rating	**Buy**
12-month price target	**CHF260.00**
Price	**CHF243.50**

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If APHINITY is "statistically significant" it is probably clinically significant

- We expect important APHINITY data soon
- Given a terse press release, how we know if the APHINITY results are good?
- In this case, statistical significance likely means clinical significance
- Valuation:

Results from Roche's important APHINITY trial are due very soon. If APHINITY is positive, Perjeta can insulate Roche from biosimilar competition against Herceptin. Around 10% of '20E EPS, ~7.5% of market cap., could be at risk on the trial outcome. APHINITY is testing Roche's Perjeta plus Roche's Herceptin plus chemotherapy versus Herceptin plus chemotherapy in the post-surgical "adjuvant" breast cancer setting.

Given a terse press release, how we know if the APHINITY results are good?
Roche's APHINITY press release will likely contain limited data on the results of the trial. Too much disclosure compromises future academic publications; important for Roche's academic/medical collaborators, and to advertise the results to potential prescribers. The press release will say whether the trial has met "statistical significance" but may say little else. So can investors be sure that a "statistically significant" result is big enough to matter to health systems and prescribers?

In this case, statistical significance likely means clinical significance
We have built tools to run robust Monte-Carlo simulations of clinical trials. We have also used various analytic statistical power calculators. We find that Perjeta will need to deliver a ~20% risk reduction for the results to be statistically significant. Therefore, we think any positive result is likely to be clinically meaningful. In the US, this is probably to lead to rapid adoption. Outside the US, we think Roche will often have to negotiate a package price for Perjeta plus Herceptin, even if results are more impressive (e.g., 30% to 40% risk reduction). In most ex-US markets, positive results in the plausible range provide a biosimilar defence strategy, rather than a major growth opportunity, in our view.

Valuation:
We focus on DCF in setting price targets (WACC 5.6%, terminal growth rate 2%), but sense-check vs. PE multiples for "core" and IFRS earnings, considering EPS growth profile and qualitative factors. Our DCF valuation supports a target price for Roche of CHF 260. This is ~17x core 2017E earnings and 23x IFRS 2017E earnings. The mean average 12-month price target for our other large-cap European drug stocks is ~15.7x core 2017E earnings or 22.1x IFRS 2017E earnings.

Trading data and key metrics

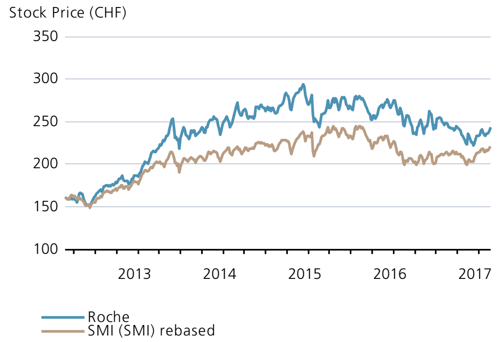
52-wk range	CHF263.80-220.10
Market cap.	CHF208bn/US$207bn
Shares o/s	691m (GENS)
Free float	98%
Avg. daily volume ('000)	1,990
Avg. daily value (m)	CHF463.3
Common s/h equity (12/17E)	CHF26.3bn
P/BV (12/17E)	7.9x
Net debt / EBITDA (12/17E)	0.5x
RIC	ROG.VX
BBG	ROG VX

Sources: UBS, Bloomberg

EPS (UBS, diluted) (CHF)

	UBS	Cons.
12/17E	15.26	15.54
12/18E	16.19	16.79
12/19E	16.70	17.81

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

Investment Thesis

Investment Case

We rate Roche a Buy because the market is failing to distinguish drug stocks that will retain earnings power from those that won't. We believe Roche will retain its power due to its unique exposure to growth in pharma sub-segments where pricing power should persist (69% of pharma revenues in 2017e). These high pricing-power revenues should grow at around 5% a year through 2022 (80% of 2022e revenues).

Company Profile: Roche

Roche is a global pharma company, which has strong franchises in oncology (including Avastin, Herceptin/Perjeta/Kadcyla, Rituxan/Gazyva; 47% of 2015 sales) and immunology, driven by R&D in both areas focused on biomarkers and companion diagnostics. In view of biosimilar competition at the end of the decade, Roche's growth drivers include Perjeta (in adjuvant breast cancer), Ocrevus (MS), Tecentriq (multiple I-O indications) and late-stage pipeline assets lampalizumab (geographic atrophy) and ACE910 (haemophilia). Diagnostics contributed 22% of 2015 group sales. Roche owns Genentech and a majority stake in Chugai.

Statement of Risk

Risks for the pharmaceutical industry include political risks, government oversight of the approval and ongoing manufacturing process, discovery bottleneck and pipeline attrition, competitive developments, patent challenges and product liability. Company-specific risks relate to the timing of onset and extent of biosimilar competition (which could affect 50% of Roche's Pharma sales) and pipeline setbacks, especially in Immuno-Oncology which is seen as critical for Roche's earnings growth and ongoing leadership position in oncology. We will also see volatility when the APHINITY trial reports (Q1 2017) and the stock will likely go down if the trial is negative. The stock may also be depressed if Novartis sells its stake.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 Roche DCF, we calculate a WACC of 5.6%. We sense-check our DCF value versus P/E multiples for both "core" and IFRS earnings. We consider EPS growth and qualitative factors. Despite cuts to our earnings forecasts, our DCF valuation still supports a target price for Roche of CHF 260. This is ~17x core 2017E earnings and 23x IFRS 2017E earnings. For comparison, the mean average 12-month price target for our other large-cap European drug stocks is ~15.7x core 2017E earnings or 22.1x IFRS 2017E earnings.

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Highlights (CHFm)	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
Revenues	47,462	48,145	50,576	52,708	55,893	59,320	61,182	64,013
EBIT (UBS)	17,636	17,542	18,420	18,875	19,910	20,452	21,029	21,977
Net earnings (UBS)	12,329	11,626	12,507	13,124	13,927	14,363	14,781	15,472
EPS (UBS, diluted) (CHF)	14.29	13.49	14.54	15.26	16.19	16.70	17.19	17.99
DPS (CHF)	8.00	8.10	8.20	8.47	9.38	9.88	9.82	13.04
Net (debt) / cash	(14,011)	(14,080)	(13,248)	(11,475)	(10,373)	(9,623)	(8,264)	(9,319)

Profitability/valuation	12/14	12/15	12/16	12/17E	12/18E	12/19E	12/20E	12/21E
EBIT margin %	37.2	36.4	36.4	35.8	35.6	34.5	34.4	34.3
ROIC (EBIT) %	45.7	39.4	40.2	40.2	41.4	40.9	40.4	40.5
EV/EBITDA (core) x	12.3	11.8	10.4	10.0	9.5	9.3	9.0	8.6
P/E (UBS, diluted) x	18.7	19.7	16.8	16.0	15.0	14.6	14.2	13.5
Equity FCF (UBS) yield %	5.5	5.0	4.8	5.2	5.3	5.3	5.6	5.8
Net dividend yield %	3.0	3.0	3.4	3.5	3.9	4.1	4.0	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 CHF243.50 on 17 Feb 2017 21:38 GMT

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UBS 12-Month Rating	Rating Category	Coverage [1]	IB Services [2]
Buy	**Buy**	45%	28%
Neutral	**Hold/Neutral**	39%	25%
Sell	**Sell**	15%	17%

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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