2017 guidance not as benign as we first thought…

This morning our first reaction to AstraZeneca’s results was one of “steady as she goes” (see here). However, we missed the trajectory of externalisation revenues and other operating income (“ooi”) for 2017. Consensus was calling for a substantial decline (from around $3.3bn in 2016 to around $2.5bn). However, the company has said the figure will likely increase.

Given new core EPS guidance that is broadly in-line with consensus for 17', the profit from externalisation and ooi must be offset by higher operating costs than consensus is currently forecasting. This in turn implies something in the order of ~$800m higher operating expenses versus current consensus. $800m is considered relatively large versus the company’s core operating profit. To give a sense of scale, it corresponds to 12% of 2016 core operating profit forecast and is roughly 25% to 30% of the implied non-externalisation and non- ooi dependent operating profit in 2017E.
AstraZeneca

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 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 AstraZeneca DCF we use a WACC 5.6% and 2% terminal growth. 2025E ROIC is 9.2%. Our price target is 5,000p. This is 15.5x 2018E “core” and 27.2x 2018E IFRS earnings. Our sector “core” 18E target multiple is 14.2 but we see AZN as having good growth.

Analyst Certification
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Highlights (US$m)

<table>
<thead>
<tr>
<th></th>
<th>12/13</th>
<th>12/14</th>
<th>12/15</th>
<th>12/16E</th>
<th>12/17E</th>
<th>12/18E</th>
<th>12/19E</th>
<th>12/20E</th>
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<tbody>
<tr>
<td>Revenues</td>
<td>25,711</td>
<td>26,547</td>
<td>24,708</td>
<td>22,918</td>
<td>21,509</td>
<td>22,237</td>
<td>23,879</td>
<td>26,649</td>
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<tr>
<td>EBIT (UBS)</td>
<td>8,390</td>
<td>6,937</td>
<td>6,902</td>
<td>6,655</td>
<td>6,483</td>
<td>6,540</td>
<td>7,283</td>
<td>8,552</td>
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<tr>
<td>Net earnings (UBS)</td>
<td>6,319</td>
<td>5,396</td>
<td>5,390</td>
<td>5,395</td>
<td>4,831</td>
<td>5,189</td>
<td>5,785</td>
<td>6,807</td>
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<tr>
<td>EPS (UBS, diluted) (US$)</td>
<td>5.04</td>
<td>4.27</td>
<td>4.26</td>
<td>4.26</td>
<td>3.82</td>
<td>4.10</td>
<td>4.57</td>
<td>5.38</td>
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<tr>
<td>DPS (US$)</td>
<td>2.80</td>
<td>2.80</td>
<td>2.80</td>
<td>2.80</td>
<td>2.80</td>
<td>2.80</td>
<td>2.80</td>
<td>3.27</td>
</tr>
<tr>
<td>Net (debt) / cash</td>
<td>(1,159)</td>
<td>(1,483)</td>
<td>(3,813)</td>
<td>(9,646)</td>
<td>(9,312)</td>
<td>(9,723)</td>
<td>(10,067)</td>
<td>(10,985)</td>
</tr>
</tbody>
</table>

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied.

For questions related to this report, please contact the global UBS Research Equity info center under ubs-cio-wm@ubs.com.

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**UBS 12-Month Rating**

<table>
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<tr>
<th>UBS 12-Month Rating</th>
<th>Rating Category</th>
<th>Coverage ¹</th>
<th>IB Services ²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy</td>
<td>Buy</td>
<td>45%</td>
<td>28%</td>
</tr>
<tr>
<td>Neutral</td>
<td>Hold/Neutral</td>
<td>39%</td>
<td>25%</td>
</tr>
<tr>
<td>Sell</td>
<td>Sell</td>
<td>15%</td>
<td>17%</td>
</tr>
</tbody>
</table>

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 Investment Research: Global Equity Ratings Definitions**

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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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