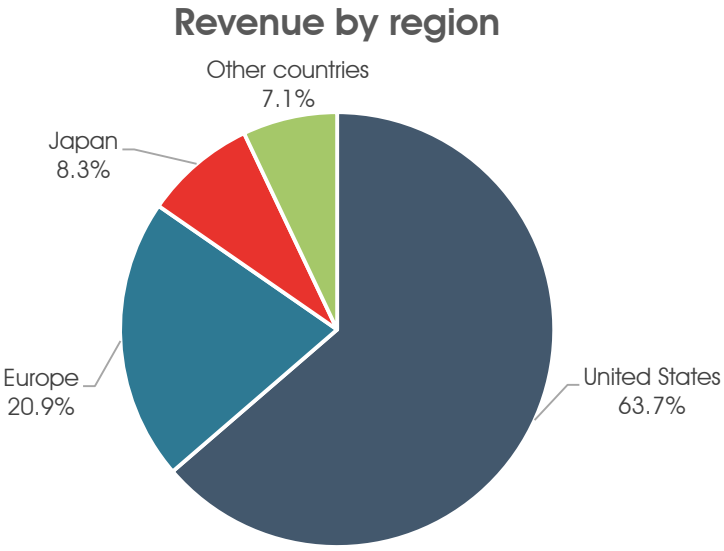
integrity asset management

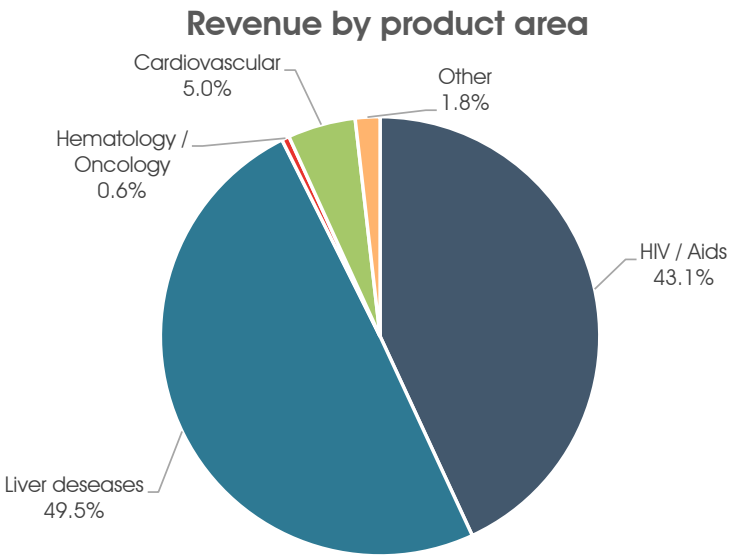
Summarised Investment Case – Gilead Sciences Inc.

Company overview:

Gilead Sciences, Inc. ("GILD") is a research-based biopharmaceutical company that discovers, develops, and commercializes therapeutics to advance the care of patients suffering from life-threatening diseases. GILD's primary areas of focus include HIV/AIDS, liver diseases (mainly Hepatitis C ("Hep C")), and serious cardiovascular and respiratory conditions. GILD was founded in 1987 in Foster City, California. Since then, GILD has become one of the largest biopharmaceutical companies in the world, with a rapidly expanding product portfolio and a growing pipeline of investigational drugs.

GILD's two main treatment areas have been in HIV and Hep C, which together accounted for approximately 93% of 2016 product sales. Gilead has several products in the pipeline that are at stages II and III of development.





Recent developments:

GILD released, as expected, a decline in first quarter 2017 revenues, proving management's guidance to be correct. The decline is due to GILD's blockbuster drug for Hep C, launched in 2013, which was down 40% from the first quarter 2016. This is not shocking news considering management's warnings, and the fact that the new treatment was actually a cure for Hep C, and that continued growth seen in prior years was unsustainable going forward. Increased pricing pressures from the public as well as competition have also contributed to downward pressure on Hep C revenues.

GILD's HIV segment is still on an upward trajectory, on the back of new products, increasing sales by 13.7% in the first quarter of 2017. This however was not enough to offset the decline from the Hep C segment, with total sales down -16.5% in quarter one. The share price has fallen 38% from its high of $119.80 in June 2015.

Patents and Pipeline:

Patent applications and approvals can be considered the most important decider of success for biotech pharmaceutical companies. Pharmaceutical development is an expensive, time consuming and uncertain process that takes years to complete. Often, patent protection expires before a new drug is approved for marketing. As a result, most pharmaceutical companies in the United States and European Union (EU) depend on the exclusivity rights, which essentially delay and prohibit competition, to recoup their considerable investment in the drug development and approval process. The product can be marketed during the period of exclusivity without any competition from its generic form. (1)

Success will depend to a significant degree on GILD's ability to:
- obtain patents and licenses to patent rights;
- preserve trade secrets;
- defend against infringement and efforts to invalidate GILD patents; and
- operate without infringing on the intellectual property of others.

GILD's core HIV portfolio is heading towards some patent expirations in 2017 and 2018. However, in 2016 GILD received approval for two tenofovir alafenamide ("TAF") – based regimens, which will replace previous treatments. These regimes have similar efficacy at one-tenth the dosage and a better safety profile than the treatments they are replacing. With an ageing HIV population, kidney and bone issues are becoming of greater concern amongst doctors, hence robust uptake of TAF regimes are expected.

Also, the introduction of new products 'Stribild', 'Genvoya', 'Odefsey', and 'Descovy' have also eased the patent expiration and sustainability concerns in their HIV segment. However, GILD will still need to work at transitioning current patients to these new TAF treatments, or risk losing market share.

In 2019, GILD will lose patent protection and sales are expected to decline for Angina drug Ranexa (currently approx. 2.3% of sales).

While GILD's pipeline is strong, with a lot of its products in the later stages of development, however, the quantity of new products is however low in comparison to its peers. CEO John Milligan has stated that low product launches, along with looming patent losses, "puts some downward pressure" on GILD and that GILD will be facing some "headwinds in 2018 and beyond". However still, he thinks the new product entrants should help significantly.

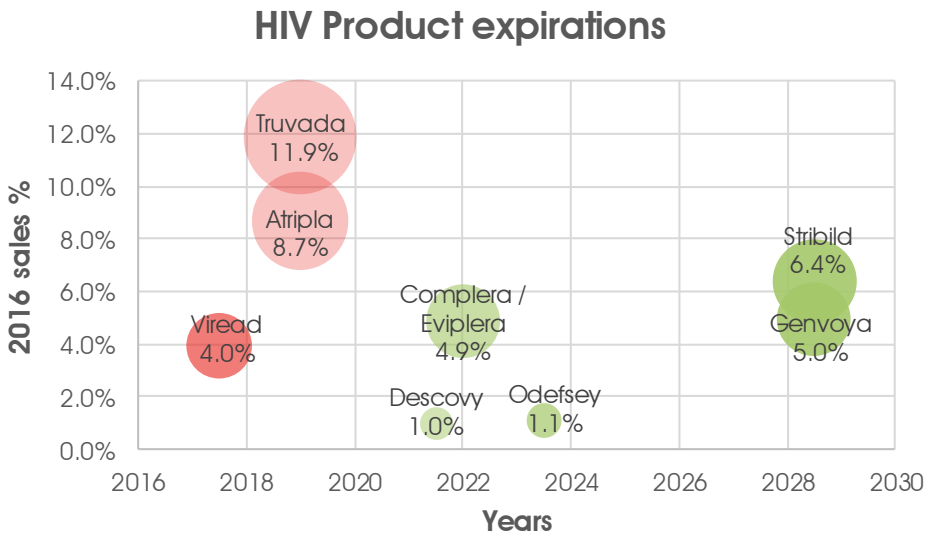
On a positive note, GILD also has potential products for a liver disease called nonalcoholic steatohepatitis (NASH) that are in the later trial stages and which are showing promising results. NASH will likely play an important role in GILD's future growth as there are currently no treatments for NASH. This does however mean that NASH is generally under-diagnosed and will therefore likely lead to slower diagnosis uptake of patients.

GILD also currently has seven Hematology / Oncology ("Oncology") products in clinical trials, with two phase III treatments in the pipeline. Oncology is currently a small proportion of GILD's revenues; however as the number of cancer patients worldwide rise, GILD has expressed interest in this segment as a potential source of growth.

Another segment showing potential contributions to future revenue is the Inflammation / respiratory segment, with eleven products in clinical trials, three in phase III and 8 in phase II. This market is however more saturated and expected growth is more sedate.

Adding to the above, GILD has the highest operating margin in the sector (five-year average close to 52%), which should help support growth in R&D investment and maintain strong free cash flows ("FCF"). Due to solid FCF generation, GILD also sits on a large cash pile (approx. $34 billion) which could also be used for acquisitions that can be used in adding value to their pipeline.

As can be seen in the below chart, GILD's strategy, and our focus on underlying confidence in their HIV segment, lies in their ability to move patients from the older, expiring, HIV products to the newer and improved TAF treatments, such as Stribild and Genvoya.



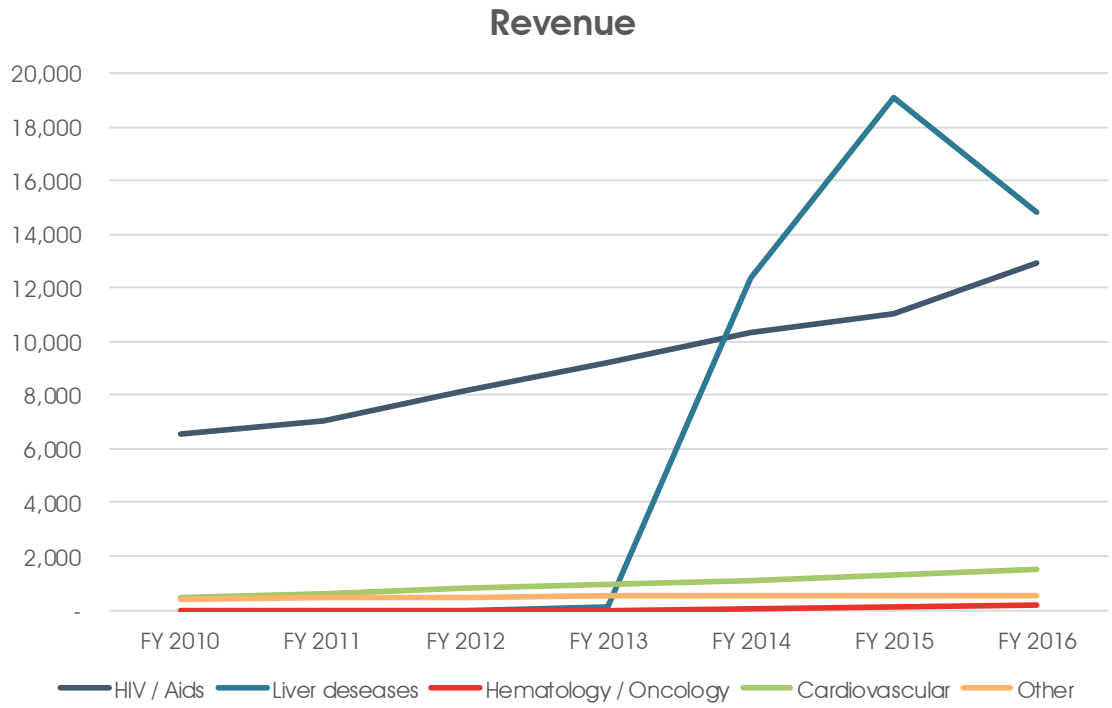
Financials

Looking back over five years GILD has been a solid performer, largely due to the blockbuster Hep C contribution, but also underpinned by stable, solid growth in the HIV segment, as well as smaller contributions from other drugs.
The following are five-year figures from 2011 – 2016:

	FY2011:	FY2016	% growth
Revenue	8,385	30,390	262.4%
EBITDA	4,092	18,791	359.2%
Invested Capital	5,159	16,909	227.8%
Free cash flow	2,387	16,060	572.9%
Net cash / (debt)	2,357	6,034	156.0%
Number of shares	1,550	1,339	-13.6%

	FY2011:	FY2016	5 year ave.
EBIT margin	45.2%	58.0%	52.4%
EBITDA margin	48.8%	61.8%	55.9%
ROE	41.6%	71.5%	57.4%
ROIC	63.7%	77.1%	65.5%

From the above, the exemplary performance that GILD has achieved over the recent past is apparent.
The growth in their operating earnings has clearly outperformed the growth in their operating assets. This has resulted in GILD generating superior FCFs, which in turn has led to GILD initiating share buy-backs, dividend pay-outs and improving their balance sheet cash position.



Valuation

Looking forward, under the following, conservative assumptions:

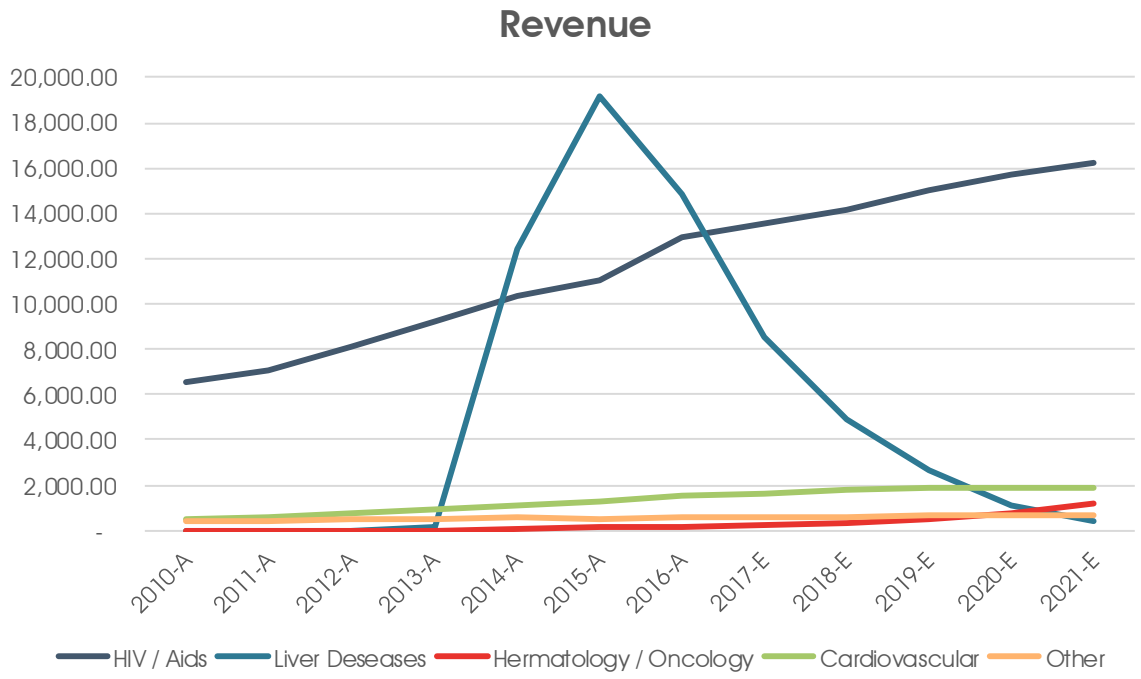
1) Sharp decline in Hep C revenues, by 97% over the next five years
2) NOPAT margins declining from roughly 53% to 35% (closer to prior Hep C levels)
3) FCF margins declining from 42% to 26%
4) WACC of 10.9%

On the above a base case DCF valuation of $75.50 per share is achieved.
Scenario adjusted on a more positive basis indicates a valuation above $90 per share.

Value drivers:	***5 year CAGR***
Revenue	*-7.4%*
NOPAT	*-12.7%*
Invested Capital	*11.3%*
FCF decline	*-21.8%*
WACC	*10.9%*
Average ROIC/WACC NAV	*79.3*
Final DCF Valuation	*75.54*

Value drivers:	***5 year CAGR***
Revenue	*-2.2%*
NOPAT	*-5.3%*
Invested Capital	*12.2%*
FCF decline	*-17.2%*
WACC	*10.9%*
Average ROIC/WACC NAV	*90.6*
Final DCF Valuation	*92.47*

Revenue forecasts:



On a relative valuation basis (against Biotech *and* pharmaceutical peers) GILD is very well placed with regards to the following valuation metrics:

Company Name	GILEAD SCIENCES INC							
Company Ticker	GILD US Equity							
Number of Peers	12							
Name	**Curr EV/Trailing 12M EBITDA**	**EV/BE EBITDA Curr Yr**	**EV/EBITDA Next Year**	**P/E**	**BEst P/E Curr Year**	**Est P/E Nxt Yr**	**P/B**	**Dividend Yield**
Average Excluding GILEAD SCIENCES INC	**20.73**	**15.39**	**13.78**	**30.14**	**21.89**	**19.47**	**8.11**	**3.12**
Gilead Pricing Premium / (Discount)	**-76.88%**	**-63.13%**	**-51.98%**	**-76.27%**	**-59.98%**	**-49.50%**	**-43.86%**	**13.25%**
GILEAD SCIENCES INC	4.79	5.68	6.62	7.15	8.76	9.83	4.56	2.71
CELGENE CORP	29.11	13.79	12.04	30.11	18.36	15.17	13.71	
BIOGEN INC	10.30	9.62	8.88	15.53	13.67	12.35	5.17	
AMGEN INC	10.21	9.69	9.73	15.46	13.96	13.63	4.17	2.39
ABBVIE INC	13.54	11.57	10.00	16.15	13.16	11.16	23.16	5.58
MERCK & CO. INC.	17.87	12.47	11.86		17.18		4.53	2.82
JOHNSON & JOHNSON	14.39	13.49	12.41	21.51	19.19	17.80	5.22	2.35
PFIZER INC	12.97	10.35	9.88	18.58	13.35	12.41	3.48	3.58
BRISTOL-MYERS SQUIBB CO	17.02	15.95	15.28	19.24	19.33	18.14	6.50	2.71
ELI LILLY & CO	23.28	15.78	14.78	26.80	20.49	19.20	6.63	2.43
REGENERON PHARMACEUTICALS	34.33	22.50	19.37	62.08	40.64	33.64	11.27	
ALEXION PHARMACEUTICALS INC	26.92	17.11	14.30	46.02	23.53	19.00	3.16	
ILLUMINA INC	38.82	32.41	26.79	60.11	49.87	41.68	10.35	

Conclusion:

We believe the negative reaction from the Hep C segment, Pipeline concerns, and pricing pressures have all been over-done and that GILD has been harshly treated compared to its peers. The share price has fallen approximately 38% since 2015. The solid free cash flow management, share buybacks, dividends, highest in sector margins, and strong balance sheet, all add to GILD's investment case. The reassuring valuation and multiples, along with stellar historical management and financials, as well as GILD's core HIV business having a stable outlook, all indicate GILD is currently undervalued.