GLAXOSMITHKLINE

ACCELERATING OUR STRATEGY: GSK TO ACQUIRE FULL OWNERSHIP OF CONSUMER HEALTHCARE BUSINESS

Tuesday, 27 March 2018
Analyst Call @ 14.00 hrs

Balbir Kelly-Bisla (Director of Investor Relations): Good morning and good afternoon everyone. Thank you for joining us to discuss the transaction we announced earlier today. You should have received our press release and can view the presentation on GSK's website. For those not able to view the webcast, slides that accompany today's call are located on the Investor section of the GSK website.

Cautionary statement regarding forward-looking statements

Before we begin, please refer to slide 2 of our presentation for our cautionary statements.

Agenda

Our speakers today are Chief Executive Officer, Emma Walmsley, Simon Dingemans, Chief Financial Officer, and Brian McNamara, CEO of our Consumer Healthcare business. Following our presentation, we will open the call to questions and answers. We request that you ask only a maximum of two questions so that everyone has a chance to participate and with that I will hand the call over to Emma.

Emma Walmsley (CEO): Thank you, Balbir, and a very good morning and good afternoon to everybody.

Balanced business to deliver growth and returns to shareholders

I am delighted to be here to discuss the announcement we made earlier today on the agreement to buy out Novartis' stake in our Consumer Healthcare joint venture. A strategic strength for GSK is our business profile beyond Pharma, the sustainable growth, returns and cashflows. Today's agreement strengthens one of our three global businesses and will support overall performance and capital planning for the group.

Advancing our priorities

Last year, I laid out my strategic priorities: Innovation, Performance and Trust, and our capital allocation framework. This transaction that we have announced today is consistent with both those priorities and this framework. Through full ownership of the Consumer Healthcare business, we aim to deliver improved performance. Very importantly, the transaction removes an inherent uncertainty for the group with the removal of the Novartis put option. This will allow us to plan use of our capital for other priorities, especially Pharma R&D.

As I have said, strengthening and investing in our Pharma pipeline is critical to support the company for its next wave of growth and we expect to give a first update to the market on our R&D plans at Q2.

Two important milestones for Consumer Healthcare

The buyout of the Novartis stake means GSK's shareholders will capture the full value of a business we believe is well positioned to deliver future sales growth and continued operating margin improvements. As Brian will come on to explain in a moment, we are confident that the investments and changes we have made to this business in recent years, building new power brands, a stronger focus on OTC and Oral Health, improved innovation capability, increased focus on digital, new operational efficiencies and, of course, building a great team, all mean we have a winning business.

To support the funding of the Novartis buyout, we are also announcing a strategic review of *Horlicks* and other Consumer Healthcare nutrition products. *Horlicks* is a terrific brand with a long history especially in India but, in the context of funding for this transaction and our desire to increase focus on our OTC and Oral Health portfolios, as well as other group capital allocation priorities, it makes sense for us to review it.

Given that the vast majority of *Horlicks* sales are sold through our Indian subsidiary, GlaxoSmithKline Consumer Healthcare Limited, which is a listed company in which we are the majority shareholder, the strategic review will include an assessment of this shareholding. We would expect the outcome of this review to be concluded around the end of 2018.

It is very important to emphasise that India remains a priority market for GSK. Consumer Healthcare will continue to invest in growth opportunities for its OTC and Oral Health brands in the country such as *Sensodyne* and *Eno*, and we are actively investing in our Pharmaceuticals and Vaccines businesses, notably with a new state-of-the-art manufacturing facility in Vemgal, Karnataka. Let me now hand over to Simon first who is going to talk through the financial highlights of this transaction.

Simon Dingemans (Chief Financial Officer): Thank you, Emma.

Financial highlights

Today's announcement to buy out Novartis' stake in our Consumer Healthcare joint venture for a consideration of £9.2 billion, marks the final leg of the three-part transaction we first announced with Novartis in 2015. As part of that transaction, we formed a highly successful joint venture and, whilst we have had a very good relationship with our partner, we have always said we would like to own the rest of the business. We like the market and the categories we are in. We think their prospects are good and that our portfolio of leading brands is well placed to generate attractive returns.

Additionally, we like Consumer cash flows in the mix of the group as they are inherently more stable and balance the significant other investments we have to support, including the R&D pipeline.

The valuation for the buyout was negotiated in a way that was consistent with the methodology set out in the existing Joint Venture Shareholders Agreement, which specifies that the joint venture should be valued as if it were a separate publically traded company with no premium applied. It also reflects our latest views and forecasts for the expected profits of the joint venture.

The agreed price of £9.2 billion is around 3% different to the undiscounted valuation we included in the year-end accounts of £8.9 billion, well within normal trading ranges.

Including the buyout, the joint venture has generated a double digit return and met our CFROI target since its formation.

Looking at the direct financial effects, the transaction will be accretive to earnings in 2018 and thereafter and will strengthen our free cash flow. We have also combined the transaction with a strategic review of the *Horlicks* business and other Consumer nutrition products. This is designed to keep us within our target credit profile, further protecting our access to capital markets and allowing us to continue to invest behind our other capital allocation priorities.

As Emma has said, for us, the transaction removes uncertainty and enables shareholders to capture the full value of the business. With 100% ownership, we now have full control to develop this business how we think best in the future.

We continue to expect operating margins of more than 20% by 2020, in 2015 exchange rate terms but we see opportunity for further margin enhancement beyond that.

Brian will talk you through some of the drivers in more detail in a moment but we expect to see operating margins for the Consumer Healthcare business approaching the mid-20s percentages by 2022 at 2017 exchange rates.

As I have said, the transaction is accretive to earnings in 2018 but we are not changing our guidance for the year today as we still need to navigate whether or not we see an *Advair* generic. As you will remember, we gave guidance for growth in adjusted EPS in constant exchange rate terms if there was no generic of 4-7% in 2018 and if there was a launch mid-year of flat to down 3%.

We will update you when we have more clarity on this but most likely not before the middle of the year.

Looking towards our 2020 outlooks, the financial benefits of the transaction further support our increased confidence to drive growth over the next two to three years and to deliver against these outlooks whilst at the same time having the flexibility to invest in the group's other capital allocation priorities, particularly R&D.

On the dividend, we continue to expect to pay 80p per share for 2018. There is no change to our dividend policy, which you will remember is based on free cash flow cover. We expect the buyout to be accretive to free cash flow.

Timing and considerations

Moving to timing and other considerations, as Novartis is a related party to GSK we are required to put the buyout transaction to a shareholder vote. We expect that to happen swiftly within the next few months with closing expected to occur around the middle of the year.

On the strategic review of *Horlicks* and the other Consumer Healthcare nutrition products, we would expect to conclude that process around the end of 2018.

The brands being reviewed amounted to sales of approximately £550 million in 2017, most of which relate to sales of *Horlicks* in India.

The review will also involve an assessment of the group's shareholding in our publically listed Indian subsidiary business and we will be consulting with their Board on this process.

Now let me hand you over to Brian.

Brian McNamara (CEO Consumer Healthcare): Thank you, Simon.

Global leader in Consumer Healthcare

With the investment in the Novartis put we now have full ownership of a world-leading Consumer Healthcare business. As a reminder, GSK Consumer Healthcare delivered £7.8 billion in net sales in 2017, roughly a quarter of the group turnover.

This is a business with attractive returns and strong cash flows. We have a very strong portfolio with seven Power brands, 11 Core brands, allowing us to compete effectively across our broad geographic footprint. Even excluding the nutrition business under review, over 35% of our business is in emerging markets.

We have a strong track record of execution delivering a sales growth CAGR of 4% over the past three years driven by high single-digit growth of our Power brands and at the same time growing margin 670 basis points to 17.7% in 2018.

We are also building the capabilities in innovation, digital and e-commerce that are preparing us to win in the current environment in the future.

Industry dynamics

Positive long term drivers

The mid to long-term trends are very favourable in Consumer Health. We know that 77% of consumers want to take more control and make more decisions related to their health. The emerging middle class is growing. An additional 2.4 billion consumers are expected to join the middle class by the year 2030. The population is ageing. There will be another half billion people over aged 60 by the year 2030 and there still continues to be unmet consumer needs that will drive innovation and growth in the categories we compete.

Industry dynamics

In addition to the long-term industry drivers, there are short-term dynamics that cause some variability in the market growth rate, some of which had an impact on the market last year. Seasonality is something that affects the market growth in any given year, specifically relating to the severity and duration of the cough-cold and allergy seasons.

Rx to OTC switches are a big driver of growth for the OTC market, but then are often followed by a year of decline by the private label entry after loss of exclusivity. While we see emerging markets as critical for the long term, their short term variability linked to economic factors or government and regulatory changes, like demonetisation and GST in India.

On emerging trends, digital represents a big opportunity for us. We're investing heavily in this area, and I will talk more about that later in the presentation.

E-commerce is a challenge and an opportunity. Globally, less than 2% of sales in the categories we compete go through e-commerce, but the channel is growing well ahead of the market, so we are not complacent, we are building the capability to win.

On local brands we are seeing much more sophisticated competition in places like China and India. Local brands are not new to the OTC market. We have been successfully competing with brands like *Eno* in Brazil and India, where we have driven double-digit growth behind strong, locally relevant innovation. We have made strong progress on local insights in R&D, and have a number of locally relevant innovations coming to the market over the next two years.

Leadership in key categories and segments

Our business is primarily focussed on OTC and oral health, where we have global scale, leading positions and a strong portfolio of brands in a combined market of over £120 billion. In OTC we hold the number one position globally, driven by our Power and Core brands in the Pain Relief, Respiratory and Digestive Health Categories. In oral health we hold the number three position globally and, more importantly, lead in Therapeutic Oral Care, which is focussed on consumer and therapeutic benefit needs, like sensitivity and gum health.

We created this segment with *Sensodyne* and *Parodontax*. We have invested and continue to invest in the science, clinical development and expert detailing. Consumers are willing to pay a premium for science-based, innovative brands that deliver results.

Our Consumer Healthcare priorities

Our strategy is to meet the everyday healthcare needs of consumers by building consumer preferred and expert recommended brands, differentiated by science and inside-driven innovation. We share the group priorities of Innovation, Performance, Trust.

We are also driving a culture change in GSK Consumer Healthcare to be more performance driven and more ambitious. My personal ambition for the business is to consistently deliver above market top-line growth, while aggressively driving margin improvement.

In 2018 on a reported basis, we expect to see low single-digit top-line growth, driven by some drags on the business, specifically divestment, the GST impact, and the TDS generic entry in the US. On an underlying basis we expect to grow above the market.

Building a competitive advantage through consumer-led, science-based innovation.

Let me spend a few minutes on how we are going to deliver the growth and margin improvement. Taking innovation first. We have a goal of building innovation into a true competitive advantage for GSK Consumer Healthcare. Winning in innovation means having a strong and differentiated pipeline and executing our launches brilliantly. There are five pillars to our strategy; let me take you through a couple of them.

The first is integrated category in R&D hubs. I believe we have a real competitive advantage, having co-located Commercial and R&D teams for each category. These teams own the overall category strategy, delivering brand assets to the markets to drive growth and creating and delivering the innovation pipeline.

The second pillar I want to mention is external innovation. At the time of the GSK and Novartis deal, about 5% of the innovation pipeline was sourced externally; today that number is close to 25%. In the last year alone, we signed 40 partnership deals, all of which are helping accelerate our pipeline.

This focus is driving a pipeline transformation

Our innovation resources and investment and focussed on Power and Core brands which align to our commercial strategy. Since 2016 we have managed to half the number of projects while increasing the pipeline value. We have seen our top-10 projects double in size. The output is a very strong set of launches over the past 12 months and in 2018 and beyond, so more work to do, but I am very happy with our progress on innovation.

A winning strategy for growth

From a performance perspective there are four pillars of our strategy. Let me go a bit deeper into a couple of them.

Building consumer preferred and expert recommended brands

Sensodyne: > £1 billion net sales and over ten years of double digit growth

Sensodyne is a fantastic brand, with over £1 billion in net sales in 2017. As you can see, it has grown over a 10-year period an average CAGR of 11% in a category that has grown 4%. The growth is driven by three things: the first is innovation. We have been able to consistently deliver a strong pipeline on *Sensodyne* based on consumer insights and meaningful benefits backed by strong science.

The second is expert recommendation, which is core to our strategy in driving brand growth. On *Sensodyne*, we are the number one recommended brand for sensitivity in over 80% of the markets we compete.

The third is world-class marketing. On a global basis we have a very clear strategy and create assets for the brand centrally. It is an extremely efficient model that works everywhere in the world.

Building consumer preferred and expert recommended brands

Voltaren: creating the world's leading topical analgesic, >£600 million net sales

We have also seen similar success in our largest OTC brand, *Voltaren*. We have been able to deliver double-digit growth CAGR for 10 years, more than twice the market. The success model leverages the same three pillars as *Sensodyne*: strong innovation pipeline, expert recommendation, and an efficient global marketing model.

Seizing the digital opportunity

The trends in digital are clear. Over half the media consumed globally is now digital in almost half the offline purchases are impacted by online information. As we know, e-commerce is changing the dynamics for our consumers, shoppers and customers, so what are we doing about it?

Investing in digital capability to win

On leadership, we hired a new Chief Digital Officer about a year ago. He was most recently at Google for three years and before that with L'Oréal. He is building a world-class team that is responsible for data, analytics and insights, content, media and e-commerce. We formed a Digital Advisory Board last year, which is made up of seven external experts who challenge our strategy, thinking and execution.

On data, we did a direct tech-stack deal with Google, which is the first within Consumer Healthcare. We now have direct access and ownership of our data, enhancing our ability to understand consumer behaviour, gather insights and become more efficient in how we deploy our media spend.

On e-commerce, we are focused on winning on the digital shelf with clear channel strategies.

And last, we are investing more in our search and programmatic media, which we know is 50-75% more efficient in reaching consumers than traditional media.

Drive gross margin improvement, operational efficiencies and cash discipline

On driving operating margin improvement, we have committed to a 20%+ margin by 2020 at 2015 constant exchange rates. We are on track and I am confident that we shall deliver that margin improvement. The key drivers are disproportionate growth on our higher margin Power brands, delivering supply chain efficiencies through streamlining our network.

To date, we have announced five plant closures, the sale of an additional plant and have reduced third party manufacturers by 25%. In addition, we are consistently leveraging our scale to drive procurement savings in the supply chain.

On A&P efficiencies, we are very ROI focused. We now have 80% of our A&P covered through marketing mix analysis, so we are continually driving optimal marketing mix and shifting resources to higher ROI opportunities.

Last and certainly not least, we are very focused on cost and cash discipline and driving leverage through all lines of the P&L.

Post-2020, we shall continue to drive operating margin and by 2022 we expect to be approaching a mid-20% margin at 2017 constant exchange rates.

Fundamentals in place to lead Consumer Healthcare

In summary, let me just say this is a fantastic business. We have category leadership, a strong pipeline and a proven track record of delivery. We are building the capabilities needed to win in an ever-changing environment and we have a clear ambition and plan to drive sustained above market top-line growth and continued operating margin improvement. Emma, let me pass it back to you.

Emma Walmsley: Thank you very much, Brian.

Accelerating our strategy

To simply summarise, the transaction we have outlined today is one that we believe accelerates our strategy, is very positive for the group and represents effective delivery of one of our key capital allocation priorities. With this transaction, GSK shareholders will capture 100% of the growth we envisage for this business. The transaction is expected to be accretive to adjusted earnings and to strengthen cashflows. Finally, and most importantly, this transaction removes a large uncertainty, allowing us to plan use of our capital for other priorities especially Pharma R&D.

With that, I shall turn the call over to the operator for any questions you may have.

Question & Answer Session

James Gordon (JP Morgan): Hello and thanks for taking my questions, I have two questions please. First, can you talk about the profitability profile of the assets you are considering divesting: is that below the divisional profitability that you hoped to get to by 2022 and would the divestments provide a margin boost? My second question is on Consumer. You have given a top-line outlook to 2020 and a margin target for 2022 but can you talk about what the top-line outlook is for 2022, and is mid-single digit possible or still low to mid?

Emma Walmsley: Thanks very much, James. I don't want to make any very specific comments on the profitability of the assets that are under strategic review, although it is not significantly different. The really important point here is that these are fantastic brands with a tremendous history and great reach. The majority of this business is in India, obviously a high potential market, and the net sales that are under review here are approximately £550 million.

In terms of the growth outlook for Consumer, you are absolutely right that growth matters and, as Brian has said, this is a sector where we see plenty of opportunity. I am not going to update our outlook beyond 2020 where we have highlighted low to mid in terms of top line. What we are really focused on is the performance of our power brands, which continue to perform competitively and, as we have said before, in the high single digits more recently. That is important because the mix impact is a key contributor to our both historic and future progress.

What we are really focused on and very confident in is the margin opportunity, as Brian said, which is absolutely on track for the 20%-plus for 2020 at 2015 rates and we are confident in this updated outlook for 2022. Thank you for the question. Next question please?

Michael Leuchten (UBS): I have two questions please. The first is on financing and I wonder if you can talk a little more about your assumptions on how you will do the financing, be that commercial paper or bonds? Then I have a question about the process here. This is not a put, if I understand correctly, but an agreement you have come to, so Novartis did not come to you and effectively put this. How come it ended up going that way as opposed to what I guess most people expected it to be which is a put and what benefit was the agreement over going down the put route? Thanks very much.

Emma Walmsley: Thanks very much, Michael. I'll hand over to Simon to talk both about the finance and some of the technicalities but you are right, we did look at using the existing put mechanism and both parties agreed that a negotiated outcome offered greater certainty and was more efficient, but this was also done consistent with the methodology that was set out in the existing Joint Venture Shareholders Agreement, as Simon mentioned.

But Simon, perhaps you might want to put some more detail on that and the financing question.

Simon Dingemans: Yes, I think the Shareholders Agreement is pretty clear as to how you should value the business when an exit arose and as I have touched on in my comments, that's really built around the framework of referencing the joint venture to existing public market comparables and valuing it as if it was a separately listed company, so that there is clear that there is no premium payable. We looked at all the relevant comparables that you would expect and compared them and our assessment of the joint venture's growth prospects and we agreed the number that we have announced today, which we think is sensibly inside the range of trading outcomes that you might judge if it was a quoted company.

I think we didn't use the put because the discussion arose in a different context and there are clear advantages in both of us having some certainty around that and in agreeing that, however, we did both also agree that we should do the valuation and the negotiation consistently with what was already in the agreement, so I think a slightly different process, the same methodology and we are both very comfortable with the outcome.

I think on funding you will understand if I don't comment precisely on how we are expecting to fund it. We have a variety of different sources and we will be locking those in over the coming months. If your question was really about what do I put in my model, then an average interest cost of somewhere between 2-3% is probably a reasonable assumption at this point for you to put in against the cost of the buyout.

Emma Walmsley: Thanks, Simon. The next question, please.

Kerry Holford (Exane): Thank you very much. Firstly just following on, please Simon on the financials, so EPS accretion you've talked about and I think that's clear but can you comment on the returns you envisage from this transaction?

And for that I struggle to see ROI for this transaction above your cost of capital over the next five years. Is that fair and is it fair really to expect payback to take longer than that given the nature of the assets you are acquiring?

And then secondly, can you just confirm that earnings accretion on the deal, the transaction you have announced today is achievable with and without the proposed asset sales that you have also introduced today? Thank you.

Emma Walmsley: Straight to you, Simon.

Simon Dingemans: Okay, so on the second question, Kerry, yes, the impact of the *Horlicks* and other nutrition businesses does not change the statement that the combined effect is accretive and clearly the amount of accretion will depend on when we close and exactly how that process unfolds.

I think on the returns, clearly when you create a joint venture and then no cash exchange is exchanged, then that adds some complexity to the calculation but the way that we are thinking about this is we have effectively, and we actually have, bought the Novartis Consumer business for the cost of the put today - £9.2 billion – on the back of an agreement we made in 2014, that closed in 2015, so I think you have to take the whole thing back to the beginning and look at the two legs together because we were always expecting and required to take the second leg as part of the original agreement, so it is a two-part transaction that we had no option but to complete on.

So we look at it as a whole and when you look at it in those terms, then we think we've made a double digit return in terms of IRR, the CFROI has picked up very nicely and is approaching those levels as we have delivered the synergies now and will improve further from here on the back of the margin progression that we have described and set out today.

That is how we are thinking about the returns. I think to just look at the put alone is only kind of half of the story.

Emma Walmsley: Thanks, Simon. The next question, please.

Hima Inguva (Bank of America): Great, thank you. Thanks for taking our questions. If you could maybe give a little bit more specifics on funding, if you are looking to issue bonds or loans, versus cash on balance sheet and also issuance timing, how you are thinking about that.

And then I saw the capital allocation priorities and Emma, your comment on that as well but if you can give us some guidance on how you are thinking about transformative M&A and valuations of assets that would be great, thanks a lot.

Emma Walmsley: I'll be very brief. On capital allocation priorities I have been clear that our first priority is to invest in our organic growth which starts with Pharma and R&D and perhaps that will include some early stage BD and you will hear more from our new Chief Scientific Officer at Q2 on that. The second priority was the put, we ticked that off now today and the third one is investing in our Vaccines capacity which is absolutely key for the exciting growth we see for that business, not least with its new assets that are underway.

The second priority was returns to shareholders through the dividend and that policy is completely unchanged and it was in fact the third priority that looked at any large scale M&A with significant discipline around returns and that has also impacted some recent decisions that we have been public on.

I have nothing more to add on that. I am not sure how much more detail Simon wants to add to the funding but I will let him answer some of your questions.

Simon Dingemans: Yes, I think, Hima, you would understand that I don't really want to get into the detail of how we might fund until we are there and have completed what we have planned other than to say that we are secure in the plan, it will be a range of different funding sources that matches the overall profile of the business, so I think I will probably stop there.

Emma Walmsley: Fantastic; we have time for one more question, please.

Vincent Meunier (Morgan Stanley): Thank you very much. The first question is very simple, very technical; it relates to the pound per US dollar rate, so will you keep the 1.42 rate unchanged, regardless of the currencies' movements, or will you take the spot rate when you will execute the payment? Is there a hedging for that one?

The second question is with regards to the review of *Horlicks* and the nutrition products. Is it more a question of critical mass or a question of product categories which is the actual trigger for that strategic review? Thank you.

Emma Walmsley: Thank you very much, Vincent. I will ask Simon to give you a brief answer to your direct question, and then I will conclude to respond on the overall.

Simon Dingemans: Vincent, to be clear, the transaction was agreed in dollars, so the price we have agreed to pay Novartis is $13 billion and yes, I do have hedging in place, so you can continue to assume 9.2.

Emma Walmsley: In terms of the question on the review for *Horlicks*, I want to be absolutely clear that this has, for a long time, been a winning and performing brand, primarily in India. There is no issue at all around critical mass in the categories of which it competes. This is about an efficient use of GSK's capital. We have long stated a priority for us was the buy-out of a business, the Novartis put, a business that we know very well, and we are confident in its outlook, and we wanted to focus within our Consumer business on the science-based brands within OTC and oral health. By announcing in combination with this deal today the strategic review of *Horlicks*, this allows us to maintain the flexibility that we want to, to support our other priorities for capital allocation and support our existing profile; the priority there being Pharma R&D. Hopefully that answers your question.

I am really looking forward to catching up with you all soon and updating with the team at our Q1 results across the broader performance of GSK. Thank you very much; have a good afternoon.

[*Ends*]