Transcript: Q2 2017 results

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Introduction

Hello and welcome to this review of GSK's results for the second quarter of 2017.

Later today we have a webcast scheduled for our investors and analysts, where we will be discussing our new priorities for the Group as well as our outlook for 2020.

For this session, I will focus on the quarter and I will also comment on our updated guidance for 2017.

Another quarter of strong operational performance

The results we've reported today reflect another quarter of strong operational delivery as well as continued investment behind key future growth drivers in each of our three businesses, particularly new product support and R&D investment in pharmaceuticals.

Our new products have had a strong quarter particularly in respiratory and HIV where the market share gains and overall growth are encouraging. In Vaccines, Bexsero, our meningitis B vaccine also saw strong growth.

Our Consumer business had a more challenging quarter in the face of a broad slowdown in key categories and tougher competition in our US allergy business. Reported growth was also impacted by approximately 2% from divestments and de-stocking ahead of GST in India.

Financial architecture continues to deliver value

Our financial architecture continues to help drive value and alignment across the business so that we prioritise our investments more clearly and allocate them to where we see the greatest returns for the future. This includes re-allocation of existing funding as well as additional spend to our highest priorities: new products, new launches and advancing the R&D pipeline.

Pharma R&D and PRV investment

In line with these priorities, we've stepped up pharma R&D spending over the last several quarters. HIV is a particular focus and during the second quarter we took the decision to invest, for the first time, in a Priority Review Voucher to accelerate the FDA's review of a key asset - our first two-drug regimen in HIV. The 106 million pound cost of the PRV was charged to R&D expenses in Q2 and - with an impact of 5% on adjusted earnings per share in the quarter - was the key driver of the reported decline in adjusted earnings per share of 2%.

Challenges, the environment, PRV and guidance

The cost of the PRV and the acceleration of certain other pre-launch investments also impact the full year outlook for 2017 and we have updated our guidance for the full year as a result. With no Advair generic expected to launch before 2018, we expect adjusted earnings per share to grow in 2017 by between 3% and 5% on a constant currency basis.

Looking further ahead, the commercial environment remains highly competitive, especially in our respiratory business where we are also seeing continued pricing pressures. We are in the middle of the contracting round for 2018 and every indication suggests that as we move into next year there will be no let up in the pricing pressures both for Advair but also the new Ellipta respiratory products as payers anticipate an Advair generic some time in 2018.

Against this market backdrop, it is critical we continue to invest to grow the market share of our recent launches, as well as prepare those that we expect to launch shortly if regulatory approval is given on the timelines expected. It is also important that we continue to invest in the pipeline and in advancing the next waves of innovation in all three businesses but particularly in Pharma.

Now let's look at the quarter in more detail.

As a reminder, our earnings release provides an extensive amount of information, so I will focus on the major points, our expectations for the remainder of 2017 and some comparators you might want to take note of for your modelling. As usual, all my comments will be at CER except when I specifically refer to currency.

Headline results & currency

Starting with the headlines: Group sales were up 3%. We had a Total loss per share of 3.7p and Adjusted EPS was 27.2p.

On currency, the weakness in Sterling compared with last year resulted in a tailwind of 9% on sales and 14% on Adjusted EPS.

Now that we have passed the anniversary of the Brexit vote and the main step change in the value of Sterling, you should expect the related exchange tailwind to diminish materially over the balance of the year.

If exchange rates were to remain in line with the rates at the end of the second quarter, we would expect the full year tailwind to Adjusted EPS from currency to be approximately 8%.

Total results

Looking now at our total results:

These include some significant charges that reflect better prospects for the group and the implementation of our new business priorities. Specifically: we have again increased the estimated valuations of our Consumer and HIV businesses, as well as the level of contingent consideration we expect to pay to Shionogi in relation to the HIV business and to Novartis as the next vaccines milestone becomes more likely. A reminder - this relates to non-US sales of Bexsero which are clearly growing strongly.

Total results this quarter also include charges of around £450 million relating to our decision to withdraw support for Tanzeum over the next 12 months or so.

The rest of my comments will be on our Adjusted results.

Sales growth

Turning to the top line, this quarter's growth of 3% was driven by continued momentum in the pharmaceuticals and vaccines business.

Pharma

Sales within the Pharma business were up 3%, despite a drag of 2 percentage points from the Aspen and Romania disposals.

Growth from new products significantly exceeded the declines in sales of older products in the portfolio.

Within Respiratory, growth of the new products – the Ellipta portfolio and Nucala – more than offset the decline in Seretide/Advair, helping to deliver global Respiratory sales growth of 4%.

We continue to prepare for the launch of our Closed Triple, which is on track for a potential approval later this year. This will be a key addition to the Ellipta portfolio, but do not expect significant sales before 2018, when we expect a steady build as we move beyond the initial launch phase.

On Seretide/Advair specifically, with no substitutable generic entry expected this year in the US, we continue to expect a decline of 15-20% globally this year, with the US in line with this range but Europe more at the 20% end.

Advair's H1 decline in the US was 12% but keep in mind this included the benefit of favourable RAR true up adjustments, which we are not expecting to recur during the second half of the year. The net impact of true ups across US Respiratory was broadly neutral as other products such as Ventolin had unfavourable adjustments.

Moving to our HIV products, overall, our HIV portfolio grew 17% in Q2. The strong growth was again driven by the continued increase in market shares for Triumeq and Tivicay. In the US, dolutegravir remains the number one core agent. Epzicom/Kivexa continues to decline as a result of generic competition in Europe.

Established Pharmaceuticals which includes most of our off-patent products declined by 7% in Q2, including a headwind from disposals of 4% and a tough comparator for Avodart in the US, due to a favourable true up in Q2 2016. Avodart is expected to encounter generic competition throughout most of Europe over the second half. I continue to expect the overall rate of decline for Established Pharmaceuticals to be in the mid to high-single digit range for the rest of the year including the impact of divestments.

Vaccines

Moving to Vaccines, sales were up 5%. This mainly reflects a continued strong performance from the meningitis portfolio, particularly for Bexsero, good growth in hepatitis sales in the US due in part to a competitor supply issue and some favourable CDC stockpile movements compared to Q2 last year. These positives helped offset the impact on growth from the reversal of the phasing benefit of shipments in Q1 that we highlighted in April, as well as an increased returns provision for Rotarix.

As I have said before, Vaccine sales are often lumpy. Q3 last year grew 20%, with the benefit of a very strong flu season and some phasing, so the business will have a tough comp in Q3.

The momentum in the business continues to give us confidence in the mid-to-high single digit outlook for sales CAGR over the medium term. But, remember the 2016 12% pro-forma growth for the full year is also a tough comparator for this year.

We continue to expect regulatory decisions on Shingrix in the US and Europe in Q4 2017. We remain excited about the prospects for this product and launch preparations are well underway, but as with Closed Triple, we do not expect a meaningful contribution from Shingrix until we get into 2018 and beyond.

Consumer

Moving to Consumer, sales were flat after a 2% drag from the combined impact of the divestment of the Nigerian drinks business at the end of Q3 last year and de-stocking associated with the implementation of GST in India which became effective at the beginning of July.

Strong performances for many of our power brands and contributions from new products were offset by the impact of some softening of the market and a weaker performance from our US allergy business, which faced increased private label and branded competition. Looking forward, the second half of the year will also be impacted by the introduction of generic competition to one of our legacy Novartis products. The impact of this on second half sales is estimated at about £40million and the full year impact next year would be around £80million.

So, given all these factors, we are not now expecting much growth at the top line from the consumer business this year. Also, unless the market backdrop improves, we would not expect more than low-single-digit growth in sales next year either, especially when you factor in the drag from divestments, GST and the Novartis generic. The slower growth we are seeing this year and the impact on 2018 are key drivers of the updated outlook for the Consumer business out to 2020 where we now expect a top line percentage CAGR over the five years of low to mid-single digits.

On the plus side, the business has made good progress improving the operating margin and we remain confident in delivering our target of getting the business getting to an operating margin of 20%+ by 2020.

Adjusted operating profit

Turning to operating profit, our Adjusted margin of 28.5% was up 60 basis points at actual rates and down 60 basis points on a constant currency basis.

Excluding the impact of the PRV, there was a 90-basis point improvement in the group operating margin on a CER basis. This was primarily driven by leverage from the sales growth in Pharma and Vaccines as well as a benefit from mix and continued tight management of our costs in all three businesses.

R&D costs were up 24%, or 11% excluding the PRV, with this increase primarily reflecting investments in the Pharmaceuticals R&D pipeline which has seen good progression in a number of priority programmes in HIV, respiratory and anaemia. We also continue to advance our earlier pipeline, particularly in oncology.

Royalties were up 12% and we continue to expect around £300m for the full year.

Restructuring

Our restructuring program has delivered its originally targeted savings of £3 billion in constant currency terms.

We are now targeting additional annual cost savings of £1 billion by 2020 primarily from the pharma business through supply chain efficiencies, simplifying our operations, improved procurement savings and more strategic supplier relationships.

The extended program is now expected to deliver total annual savings of £4 billion by 2020 in constant currency terms with an anticipated currency benefit of £0.4 billion if Sterling stays at current levels.

Total cash charges for the extended programme are expected to be approximately £4.1 billion, an increase of about £450 million above the previous allocation for the programme. The total non-cash charges are expected to be up to £1.6 billion, an increase of around £250million over the original allocation.

Operating profit to net income

Turning to the bottom half of the P&L, interest costs were up slightly due to higher net debt, in line with expectations.

The tax rate was 21.2%, similar to last year. And we continue to expect to be in the 21-22% range for 2017 as a whole.

Minorities were also up, mainly reflecting growth in the Consumer and HIV joint ventures.

Cash generation and net debt

On cash flow and net debt, free cash flow for the Group during the first half of the year was £368m, up over £300m compared with last year, even after the £106 million investment in the PRV in Q2 and a significant increase in inventory, as planned, for shipments and launches during the second half. The inventory build during the first half offset significant progress in many areas including tighter management of capex and reduced restructuring spend.

Net debt now stands at £14.8bn, slightly less than this time last year and £1bn higher than year-end 2016, primarily reflecting £2.0 billion of dividends paid to our shareholders only partly offset by free cash flow and disposal proceeds.

Due in part to a significant seasonal impact on parts of the Group's businesses including flu vaccines sales and respiratory products, we expect free cash flow for the year to be significantly weighted to the second half.

Conclusion

So in conclusion, Q2 represented another quarter of progress underpinned by a strong focus on execution. While adjusted earnings per share were down 2%, the investment made in the quarter in the PRV is in line with our capital allocation and new business priorities and strengthens our HIV business, one of our key, long term growth drivers.

We continue to expect to return an 80p dividend for 2017 and we have also announced today an expectation that, subject to any material change in the external environment or performance expectations, we will pay a dividend of 80p per share in 2018 as part of a new dividend policy established for 2018 and beyond. This new policy sets out our objective to distribute regular dividend payments that will be determined primarily with reference to free cash flow generated after funding the investment necessary to support growth.

Over time, the Group intends to build free cash flow cover of the dividend to a target range of 1.25 to 1.5 times before returning the dividend to growth.

I encourage you to review our press release for further details and welcome you to join our webcast later today.

Thank you.

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