

AbbVie Inc ABBV |

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AbbVie's outlook depends highly on a well-positioned Humira and late-stage pipeline drugs.



by [Damien Conover](#)

Investment Thesis 10/31/2014

Armed with a best-in-class immunology drug Humira, AbbVie is well-positioned to drive strong cash flows to support the company's next generation of pipeline drugs. At over 50% of total sales and a higher portion of earnings (due to higher margin revenue), Humira is well positioned to drive the majority of AbbVie's performance over the next three years. With approvals in rheumatoid arthritis, psoriasis, and Crohn's disease, Humira should continue to grow in these markets as penetration rates are below 25% on average. With leading efficacy and a favorable side-effect profile, we expect Humira to continue to post double-digit growth over the next couple of years.

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Analyst Note

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Despite a strong near-term outlook for Humira, uncertainty around encroaching competition will likely weigh on investor sentiment toward the company. In particular, Pfizer's new RA drug, Xeljanz, represents a key new competitor, as it offers similar efficacy and oral dosage (in contrast to twice-monthly Humira injections). Also, while Humira's biologic composition may deter generic completion following the late-2016 patent loss in the U.S. and the 2018 patent loss in Europe, we model in 20% annual revenue declines for Humira by 2019.

Beyond Humira, a combination of products losing patent protection and mature drugs largely represents sales outside of Humira. The company's testosterone drug Androgel will likely face generic competition in 2015. In addition, many of the other remaining products have already lost patent protection, but due to manufacturing complexities have been able to retain a significant portion of sales.

Looking ahead, AbbVie's pipeline is weighted heavily toward 2015 launches, with its hepatitis C drugs representing the crown jewel in the pipeline with upside reaching over \$3 billion annually. We expect this hepatitis C treatment to carry very high margins based on the favorable efficacy data enabling strong pricing power. Further, we expect the 2015 launch year to show a high trajectory of sales growth given the limited treatment options in hepatitis C.

Economic Moat 10/31/2014

We believe AbbVie supports a narrow moat based on patent-protected drugs, intellectual intangibles and a powerful salesforce. As is the case for most drug firms, the core of AbbVie's moat lies in its portfolio of patent-protected drugs. However, unlike AbbVie's Big Pharma peers, which tend to carry wide moats, one drug (Humira) represents the majority of AbbVie's sales (50%) and profits (greater than 70%). As a result of both emerging branded competition to Humira in the immediate term and a potential generic biosimilar threat in the 2017-18 time frame, we believe excess returns are likely to persist for 10 years, but we cannot be as certain of this for our 20-year outlook, which would be needed for a wide moat rating. Further supporting our narrow moat rating, AbbVie holds a relatively weak pipeline with a high concentration of new drugs in the very competitive hepatitis C market. A stronger pipeline and a more diverse product lineup would be needed for a wide moat rating.

Nevertheless, AbbVie derives enormous cash flows from its current product portfolio to fund ongoing discovery and development of the next generation of drugs. The large cash flows create an economy of scale that enables AbbVie to fund

Morningstar's Take ABBV

Analyst		
Price 11-19-2014	Fair Value Estimate	Uncertainty
65.5 USD	61 USD	Medium
Consider Buy	Consider Sell	Economic Moat
42.7 USD	82.35 USD	Narrow
Morningstar Credit Rating	Stewardship Rating	
A-	Standard	

Bulls Say

- AbbVie supports a strong dividend yield of more than 3%, which should act as valuation support, as the cash flows to support the dividend are very secure over the next few years.
- We believe Humira represents one of the best immunology drugs for RA, Crohn's disease, and psoriasis, and we expect it will continue to penetrate these markets.
- The new competitive RA threat from Pfizer's Xeljanz will not likely take much share from Humira initially as Xeljanz's safety and efficacy profile is still uncertain and the drug requires heavy monitoring during usage.

Bears Say

- Several of AbbVie's pipeline products are partnered with other drug companies, which reduces the profit potential of the new drugs.
- The poor competitive position of HIV drug Kaletra will likely mean a slow sales decline over the next four years, creating a drag on overall company growth.
- Besides the hepatitis C drugs, AbbVie's pipeline prospects are not as strong as the company needs to help ensure long-term growth following the Humira patent loss.

Competitors ABBV

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Name	Price	% Chg	TTM Sales \$ mil
AbbVie Inc	\$65.50	-0.83	19,619
Johnson & Johnson	\$108.76	-0.06	74,432
Novartis AG ADR	\$95.73	0.16	60,023
Novartis AG	\$95.11	-0.36	60,023
Pfizer Inc	\$30.44	-0.49	50,045
Merck & Co Inc	\$59.64	-0.42	43,075

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Health Care a Leader in Moat Stocks

the average \$800 million required for a new drug. While not as strong as other Big Pharma firms, AbbVie's R&D has created a database of intellectual insights that should help increase the odds of successful drug development. Finally, AbbVie's entrenched sales force in one of the most sought-after therapeutic areas of immunology should help the firm launch its next generation of drugs and make the company a leading candidate for smaller drug firms needing help to develop and commercialize innovative new drugs.

Valuation 10/31/2014

We are raising our fair value estimate to \$61 per share from \$54 based on increased sales projections for Humira and higher-margin assumptions for the company's hepatitis C treatment. As the most valuable pipeline assets, the hepatitis C drugs look well-positioned to add to the company's overall growth. Based on the strong launch from Gilead's hepatitis C drug Sovaldi, we expect peak sales for AbbVie hepatitis C drugs to reach \$4.5 billion. However, Humira is still the most important drug for AbbVie. Accounting for more than half of AbbVie's projected 2014 sales, Humira is the key driver of its valuation and outlook. We believe Humira's leading efficacy and relatively clean side-effect profile in underpenetrated treatment areas, including RA, psoriasis, and inflammatory bowel disease, will drive an 13% three-year CAGR for the drug. However, we expect Humira sales will begin to decline approximately 20% by 2019 as generic biologics increase and greater branded competition intensifies, which lowers our 10-year CAGR for the drug to negative 6%. Aside from Humira, AbbVie holds several drugs that are losing patent protection over the next five years, which offsets the near-term Humira growth and results in a total sales five-year CAGR of 7%. On the bottom line, over the next five years we expect improving margins, largely driven by the higher contribution to total sales by Humira and hepatitis C drugs, both of which carry very high margins. For the weighted average cost of capital, we use an 8% rate that combines a 8% cost of equity and market rates for the cost of debt.

Risk 10/31/2014

Similar to other drug companies, AbbVie faces the risks of new product failures, reimbursement challenges for new drugs, and drug pricing cuts by large payer groups that are growing increasingly price-sensitive. Further, AbbVie's high concentration of Humira sales makes the company very exposed to any new competitive threats to Humira. Key emerging competitive threats to Humira include Pfizer's oral RA drug Xeljanz, cheaper generic versions of Remicade in Europe, and several other Phase III drugs that hold very strong efficacy or more convenient dosing than Humira.

Management 10/31/2014

We believe AbbVie's management team has demonstrated Standard stewardship, as the key leaders haven't had much of a track record yet. While the failed acquisition attempt for Shire is concerning, we believe the new abrupt U.S. Treasury laws largely caused the acquisition to collapse, somewhat giving management a pass. Nevertheless, the \$1.6 billion breakup fee related to the failed Shire deal does show that management didn't gauge the political landscape correctly.

Turning to management specifically, AbbVie is led by Rick Gonzalez, who joined Abbott in 1977 and held many managerial posts throughout his career there. However, he only recently led the drug group starting in July 2010 after a brief retirement. His relatively short tenure in the key field of drug commercialization and development is a concern, but execution has been going well under his leadership. Backing up Gonzalez, CFO Bill Chase has been with Abbott for more than 20 years. Chase's background in licensing and acquisitions will be helpful, as AbbVie will need to redeploy the strong cash flows from Humira into acquisitions and partnering to augment the company's light pipeline.

Overview

Profile:

AbbVie is a pharmaceutical company with a strong exposure to immunology and virology diseases. The company's top drug, Humira, represents over half of the firm's profits. The company was spun off from Abbott in early 2013.

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