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AbbVie Inc ABBV |

Quote Chart **Stock Analysis** Performance Key Ratios Financials Valuation Insiders Shareholders Transcr

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AbbVie's outlook depends on late-stage pipeline drugs being able to offset Humira competition.



by
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Analyst Note 07/29/2016

Buoyed by immunology drug Humira once again, AbbVie posted solid second-quarter results, slightly ahead of both our and consensus expectations, but we don't expect any changes to our \$73 fair value estimate and continue to view the stock as undervalued. Despite our \$10 billion 2020 estimate for Humira, which is significantly below consensus expectations of \$18 billion, we believe the pipeline is underappreciated, especially with immunology drugs ABT-494 and risankizumab. The pipeline gives us confidence in both the company's valuation and narrow moat.

In the quarter, Humira sales topped our estimate and the company increased Humira full-year 2016 U.S. guidance to over 20% growth, ahead of our projection, but given our projected declines by 2018, the near-term performance doesn't significantly impact our valuation. Further, while the U.S. growth of Humira was strong, up 27% year-over-year, internationally, Humira only gained 4%, suggesting a modest impact from Enbrel and Remicade biosimilars along with increased pressure from Novartis' psoriasis drug Cosentyx. While we expect continued strength from Humira before biosimilars launch, the drug should begin to decline in 2018 following a litigation period after the U.S. composition of matter patent expires in December 2016.

Despite the expected eventual headwinds for Humira, AbbVie's recently launched oncology drugs and strong pipeline in immunology should mitigate Humira biosimilar pressures in 2018 and beyond. Cancer drug Imbruvica continues to expand indications in hematology and post excellent data, reaffirming our annual

Morningstar's

Analyst

Price 08-18-2016
66.77 USD

Consider Buy
51.1 USD

Stewardship Rating
Standard

Bulls Say

- AbbVie supports a should act as valu the dividend are f
- AbbVie's increasin bode well for grow strong in this area
- AbbVie's next gen and JAK pathways headwinds facing

Bears Say

- Several of AbbVie other drug compa of the new drugs.
- The side effects er weigh on the com market.
- AbbVie's pipeline the eventual sales increased biosimil

peak sales estimate of over \$5 billion. Further, we expect the drug's entrenchment to limit the competitive threat from Astra's acalabrutinib, which could have a better side-effect profile. Also, ABT-494 and risankizumab hold blockbuster potential as the drugs look well positioned on both efficacy and side effects to take share from the TNF class.

Competitors ABBV

Name
AbbVie Inc
Johnson & Johnson
Pfizer Inc
Novartis AG ADR
Novartis AG
Merck & Co Inc

Investment Thesis 06/10/2016

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.

Despite a strong near-term outlook for Humira, uncertainty around encroaching competition will likely weigh on investor sentiment toward the company. In particular, new JAK inhibitors and IL-17 antibodies represent major drug advancements in rheumatoid arthritis and psoriasis, which will likely lead to some market share losses for Humira. 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 close to 20% annual revenue declines for Humira by 2019.

Beyond Humira, cancer drug Imbruvica is poised to become the next biggest sales contributor. Imbruvica's strong clinical data in several forms of blood cancer should lead to peak sales above \$6 billion. AbbVie's remaining drugs are largely mature with patent expirations long past, but have manufacturing or specific dosing complexities which make generic competition less likely.

Looking ahead, AbbVie's pipeline is weighted heavily toward new cancer drugs. In particular, AbbVie's pipeline should lead to an increasingly strong position in blood cancer. The company should be able to leverage its solid entrenchment with Imbruvica to launch the new drugs.

Economic Moat 06/10/2016

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 (more than 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 needs to improve its pipeline to be more ready for the eventual biosimilar competition to Humira.

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 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 salesforce 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 06/10/2016

We are increasing our AbbVie fair value estimate to \$73 from \$65 largely due to increased expectations for the company's next generation immunology drugs targeting the IL23 and JAK pathways as these next pathways seem to offer better efficacy and an improved side effect profile. However, our \$28 billion 2020 total sales projection remains well below management's guidance of \$37 billion, with the primary difference regarding immunology drug Humira. While management is projecting 2020 Humira sales at more than \$18 billion, we project Humira sales at \$10 billion. We anticipate quicker launches of biosimilar versions of Humira after the December 2016 patent loss in the U.S. However, AbbVie believes other less-powerful patents will keep biosimilars off the market much longer. Helping offset the likely eventual Humira sales declines, cancer drug Imbruvica holds strong blockbuster potential in blood cancers. Also, the company has several other late-stage cancer drugs that should further help mitigate the eventual Humira sales declines. On the bottom line, over the next three years we expect improving margins, largely driven by the higher contribution to total sales by specialty drugs, which carry very high margins. For the weighted average cost of capital, we use a 7.5% cost of equity and market rates for the cost of debt.

Risk 06/10/2016

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 significantly exposed to any new competitive threats to Humira, both from biosimilars and new branded competition.

Management 06/10/2016

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. Further, the \$21 billion Pharmacyclics acquisition appears to be a fair use of capital if Imbruvica reaches our \$6 billion peak sales projection.

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 developing pipeline.

Overview

Profile:

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

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