

Elanco Animal Health

\$1.3bn Aqua divestment to jump-start Elanco's debt paydown

Maintain Rating: BUY | PO: 18.00 USD | Price: 15.90 USD

Unexpected asset sale to Merck AH

On 2/5, Elanco (ELAN) announced an agreement to sell its aquaculture business to Merck Animal Health, a division of Merck (MRK, covered by Geoff Meacham), for \$1.3bn in cash (~7.4x FY23 sales or ~14.1x FY23 adj. EBITDA). We were not expecting such a move, and we see positive and negative aspects to the deal. We agree with the rationale for the move and think the company is now better positioned in 2024 and beyond. We maintain our Buy rating and look forward to ELAN's 4Q print (Feb. 26th), presentation at our BofA Animal Health Summit (Feb. 29th), and updates on anticipated product launches.

The Good: Faster de-leverage (now ~4.5x by end of '24)

Once the deal closes (mid-2024), Elanco will use the after-tax cash proceeds (\$1.05bn-\$1.1bn) to pay down a portion of the Term Loan B debt. ELAN highlighted that FY23 ended with net-debt to Adj EBITDA slightly below midpoint of prior range, implying ~5.6x. If 2023 results were pro-forma adjusted for the Aqua sale, leverage would be 5.0x or below. For 2024/2025, ELAN now expects leverage of ~4.5x and ~4.0x, due to the debt paydown from cash proceeds, and improving FCF from base business. Elanco's elevated leverage has been a pressure point on shares for several quarters, and the Aqua deal significantly accelerates a return to more normal leverage ratios.

The Bad: Losing a fast-growing, very profitable biz.

The Aqua biz does not get as much air-time as more popular markets like parasiticides and dermatology, but it is an attractive part of Elanco's portfolio. ELAN disclosed FY23 revenues of \$175mn (with a +HSD multi-year sales CAGR), and Adj EBITDA of \$92mn, well-above company average. Elanco was one of the leaders in aquaculture, with Zoetis (ZTS) also having a sizable market position in this attractive market. Mgmt's rationale for being willing to part ways with such an attractive asset is that the long-term upside in aqua was limited, given the still relatively small market opportunity. Instead, ELAN will now be able to focus even more on the near-term opportunities in key product areas where innovation is expected (mgmt. also reiterated all prior guidance re: timing of product approvals/launches in 2024).

A cleaner, healthier Elanco comes into view

We will update our model closer to deal-close, and believe ELAN will initially guide inclusive of Aqua (and provide an updated guide at mid-year). Still, given the pro-forma estimates for debt paydown, interest expense (\$65mn better), and Adj EPS (+11c from less interest expense, but offset by -14c from lower operating income), the deal goes far to remove the 'leverage' overhang on ELAN shares. With much-anticipated approval/launch announcements expected in coming months for Credelio Quattro, Zenrelia, and Bovaer, Elanco is moving closer to delivering on the business transformation that's been long-promised. We are encouraged by the steady progress on all fronts, and see the announced deal as another step in the right direction.

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Stock Data

Price	15.90 USD
Price Objective	18.00 USD
Date Established	27-Oct-2023
Investment Opinion	B-1-9
52-Week Range	7.88 USD - 15.94 USD
Mrkt Val (mn) / Shares Out (mn)	7,836 USD / 492.8
Free Float	99.4%
Average Daily Value (mn)	74.01 USD
BofA Ticker / Exchange	ELAN / NYS
Bloomberg / Reuters	ELAN US / ELAN.N
ROE (2023E)	7.2%
Net Dbt to Eqty (Dec-2022A)	75.3%
ESGMeter™	High

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Price objective basis & risk

Elanco Animal Health (ELAN)

Our \$18 PO is based on 14x our FY24 EV/EBITDA estimate.

Our target multiple is a roughly 5x discount to the company's closest animal health peer, given the slower sales growth and lower margin profile, but reflects some expectation of further improvements by Elanco.

Downside risks to our price objective are continued pressure from negative news flow on Seresto safety, market challenges from ongoing Coronavirus outbreak, deal integration challenges, competitive and generic launches for key products, slower-than-expected ramp for new product launches, increased regulation on antibiotic use in livestock, macroeconomic conditions, and currency risks..

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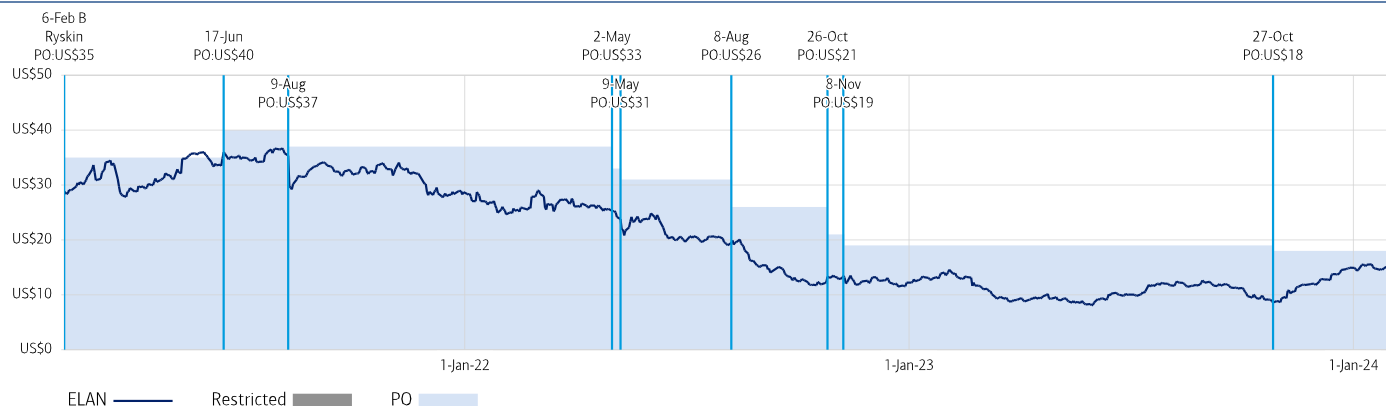
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Important Disclosures

Elanco Animal Health (ELAN) Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	234	60.94%	Buy	115	49.15%
Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

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Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
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