

May 05, 2015

Catalent, Inc.

Fiscal Third-Quarter Analysis; Steady Results Despite Foreign-Exchange Headwinds

- Conclusion.** On Tuesday evening, Catalent reported fiscal third-quarter earnings of \$0.46 per share, which beat our estimate by 3 cents and the consensus by 2 cents. Compared to our model, revenue was a modest headwind (0.5 cents), but was offset by better EBITDA margin (3.2 cents) thanks to very robust results in the Oral Technologies segment. In addition, the company made a small pharmaceutical packaging acquisition in Australia, continuing the consolidation strategy that has been consistent so far as a public company (three small purchases in the three quarters since coming public).
- Despite these solid results, foreign-exchange headwinds and slight deterioration in the European Development and Clinical Services segment drove a reduction in guidance for the balance of the year. Management reduced full year guidance by \$20 million to \$35 million on the top line and roughly \$6 million to \$8 million on the bottom line. Given this headwind, we are reducing our estimates for fiscal 2015. We now expect fiscal 2015 EPS of \$1.63, which is down 7 cents from our prior target and down 14% from fiscal 2014. Despite the significant foreign-exchange headwind, we are pleased with the stronger fundamentals on a constant-currency basis, and reiterate our Outperform rating.
- Financial Details.** Third-quarter revenue of \$446.6 million came in \$4 million below our expectations due to a stiff foreign-exchange headwind of about 900 basis points. Constant-currency growth of 8% was ahead of our 7% expectation, driven by Oral Technology's 10% gain versus our 5% target. Development and Clinical Services growth of 4% was below our 13% expectation (hurt by Europe), and Medication Delivery growth of 2% was below our 6% expectation. On an as-reported dollar basis, Oral Technology was \$5 million better than our model, and Development and Clinical Services and Medication Delivery were \$5 million and \$3 million lower, respectively. Commentary on the call was quite positive, suggesting that the company's pipeline or recent and pending wins is expanding. Positive mix shifts in Oral Technologies and Medication Delivery, strong performance from the high-margin product participation portfolio, solid new product wins (120 new compounds added year-to-date), biologics growth of 70% (off a small base of 1% of revenue), and expansion into the animal health market should drive sustainable long-term growth in line with our previous midsingle-digit expectations.
- Though a major transaction has yet to be announced, the company continues to make progress on its strategy to roll up share through deals. Management announced the acquisition of PharmaPak, a small commercial packaging company based in Australia. We believe the company generates roughly \$20 million in annual revenue and \$4 million to \$6 million in adjusted EBITDA. While not particularly material in the near term, the dose manufacturing market has abundant M&A opportunities, and we expect management will continue to buy tuck-in assets in the coming quarters. We assume biologic assets will be a particular focus area given the company is underrepresented in this key product category.

Catalent is the world's leading provider of advanced delivery technologies to the pharmaceutical industry. The company was purchased by The Blackstone Group in 2007 from Cardinal Health and is based originally on R.P. Scherer's softgel manufacturing technology patented in 1934. The company operates in 27 facilities in five continents, and manufactures more than 70 billion doses of medication annually.

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Stock Rating: **Outperform**
Company Profile: **Established Growth**

Symbol: CTLT (NYSE)
Price: \$29.18 (52-Wk.: \$19-\$32)
Market Value (mil.): \$3,617
Fiscal Year End: June
Long-Term EPS Growth Rate: 11%
Dividend/Yield: None

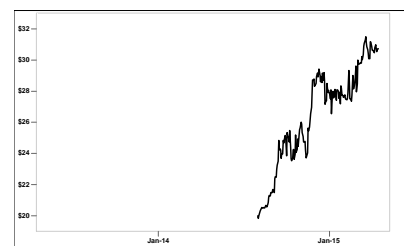
	2014A	2015E	2016E
Estimates			
EPS Q1	\$-0.02	A\$0.13	NA
Q2	\$0.37	A\$0.44	NA
Q3	\$0.52	A\$0.46	NA
Q4	\$1.01	\$0.55	NA
FY	\$1.89	\$1.63	\$1.77
CY		\$1.67	\$1.94

Valuation			
FY P/E	15.4x	17.9x	16.5x
CY P/E		17.5x	15.0x

Trading Data (FactSet)			
Shares Outstanding (mil.)			124
Float (mil.)			124
Average Daily Volume			510,963

Financial Data (FactSet)			
Long-Term Debt/Total Capital (MRQ)			0.0
Book Value Per Share (MRQ)			4.0
Return on Equity (TTM)			0.0

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

- **Fiscal 2015 Model Changes.** We now model fiscal 2015 revenue for Catalent of \$1,817 million, down 0.6% from fiscal 2014 and down \$23 million from our previous model. We now model a currency headwind of 645 basis points, up from 600 basis points previously. On a constant-currency basis, we now expect revenue growth of 5.9%, down slightly from our previous 6.1% estimate. We expect adjusted EBITDA margin of 23.9%, down from 24% previously. We now expect fiscal 2015 EPS of \$1.63, which is down 7 cents from our prior target.
- **Fiscal 2016 Model Changes.** We now model fiscal 2016 revenue of \$1,867 million, up 2.7% from our fiscal 2015 estimate, but down \$40.5 million from our previous model. We model a currency headwind of 340 basis points, up from 210 basis points previously. On a constant-currency basis, we expect revenue growth of 6.2%, up slightly from our previous 5.8% target. We expect adjusted EBITDA margin of 25.3%, up from 24.5% previously. We now expect fiscal 2016 EPS of \$1.77, which is down 5 cents from our prior target.
- **Valuation and stock thoughts.** Following the changes to our model, CTLT now trades at 15.0 times our adjusted calendar 2016 EPS target of \$1.94 (or 21.6 times our fully taxed calendar 2016 estimate of \$1.35). On an EV/EBITDA basis, the stock trades at 11.0 times our revised 2016 expectation. Comparatively, the CRO peer group trades at 18.6 times 2016 EPS (18.0 times excluding WX) and 13.5 times EV/EBITDA (12.7 times excluding WX). Despite the foreign-exchange headwind and slight deterioration in the European clinical business, we are encouraged with the company's underlying results and view the relative valuation as reasonable for this very durable business model. As such, we maintain our Outperform rating on CTLT. Our updated model and several exhibits detailing results relative to our expectations and updated guidance are summarized below.

Exhibit 1. Fiscal 2015 Guidance Relative to Previous Expectations

	Fiscal 2015 Guidance		Fiscal 2015 Estimates	
	Current	Previous	WB	Consensus
Revenue (\$M)	\$1,800 to \$1,825	\$1,820 to \$1,860	\$1,840	\$1,845
Growth	(1.5%) to (0.2%)	(0.4%) to 1.8%	0.7%	0.9%
Adjusted EBITDA	\$428 to \$436	\$434 to \$444	\$440.7	\$439
Growth (decline)	(1.1%) to (0.8%)	0.3% to 2.6%	1.9%	1.5%
Adjusted Net Income	\$197 to \$205	\$204 to \$214	\$209.3	NA
Growth (decline)	38% to 44%	43% to 50%	46.98%	NA

Source: William Blair estimates, FactSet, and Company reports

Exhibit 2. Fiscal Third-Quarter EPS Performance Relative to William Blair Expectations

Revenues	\$ (0.005)
Gross Profit	\$ (0.009)
SG&A	\$ 0.041
Depreciation	\$ 0.007
Net interest income (expense)	\$ (0.026)
Taxes	\$ 0.006
Share Count	\$ 0.008
Total	\$ 0.022

Source: William Blair estimates and Company reports

Exhibit 3. Fiscal Third Quarter Variance to William Blair Model

	3Q FY15 (Actual)	3Q FY14 (Actual)	Year/Year % Change	3Q FY15 (Estimate)	Year/Year % Change
Net revenues	\$ 446.6	\$ 453.1	-1.4%	\$ 450.7	-0.5%
Cost of revenue	279.6	281.4	-0.6%	280.8	-0.2%
Gross profit	167.0	171.8	-2.8%	169.9	-1.1%
SG&A	56.5	65.7	-14.0%	63.1	-4.0%
EBITDA	110.5	106.0	4.2%	106.8	0.7%
Depreciation	22.6	24.2	-6.6%	23.9	-1.3%
EBITA	87.9	81.8	7.4%	82.9	1.3%
Net interest income (expense)	(23.0)	(40.4)	-43.1%	(19.2)	-52.4%
Pretax income	64.9	41.4	56.8%	63.7	53.8%
Income tax expense	7.3	2.5	192.0%	8.0	218.4%
Adjusted Net income	57.6	38.9	48.1%	55.7	NM
GAAP Net Income	30.8	6.3	388.9%	42.3	NM
Diluted shares outstanding	126.3	74.8	68.8%	128.5	71.8%
Adjusted EPS	\$ 0.46	\$ 0.52	-12.3%	\$ 0.43	NM
GAAP EPS	\$ 0.24	\$ 0.08	189.5%	\$ 0.33	291.2%
Gross profit	37.39%	37.9%	-0.5%	37.70%	-0.2%
SG&A	12.65%	14.5%	-1.9%	14.00%	-0.5%
EBITDA	24.74%	23.4%	1.3%	23.70%	0.3%
Depreciation	5.06%	5.3%	-0.3%	5.30%	0.0%
EBITA	19.68%	18.1%	1.6%	18.40%	0.3%
Pretax income	14.53%	9.1%	5.4%	14.13%	5.0%
Tax rate	11.25%	6.0%	5.2%	12.50%	6.5%
Adjusted Net Income	12.90%	8.6%	4.3%	12.36%	3.8%
GAAP Net Income	6.90%	1.4%	5.5%	9.39%	8.0%
Segment Breakdown	3Q FY15 (Actual)	3Q FY14 (Actual)	Year/Year % Change	3Q FY15 (Estimate)	Year/Year % Change
Oral Tech Revenue	284.0	287.3	-1.1%	279.4	-2.8%
Oral Tech EBITDA	81.7	76.2	7.3%	78.2	2.7%
% margin	28.8%	26.5%	2.3%	28.0%	1.5%
Medication Delivery Solutions Revenue	61.2	65.4	-6.4%	64.3	-1.8%
Medication Delivery Solutions EBITDA	10.9	15.7	-30.7%	11.6	-26.5%
% margin	17.8%	24.1%	-6.2%	18.0%	-6.1%
Development & Clinical Services Revenue	103.7	103.7	0.0%	109.1	5.2%
Development & Clinical Services EBITDA	23.8	23.0	3.5%	20.2	-12.2%
% margin	23.0%	22.2%	0.8%	18.5%	-3.7%

Source: William Blair estimates and Company reports

Exhibit 4. Updated Catalent Financial Model, 2011 through 2017(E)

	2011	2012	2013	2014	Q1'15	Q2'15	Q3'15	Q4'15E	2015E	2016E	2017E
Net revenue	\$1,531.8	\$1,694.8	\$1,800.3	\$1,827.7	\$418.3	\$455.8	\$446.6	\$496.5	\$1,817.2	\$1,866.8	\$1,964.1
Cost of revenue	\$954.0	\$1,056.1	\$1,143.8	\$1,145.7	\$272.9	\$284.6	\$279.6	\$308.8	\$1,145.9	\$1,157.8	\$1,214.9
Gross profit	\$577.8	\$638.8	\$656.5	\$682.0	\$145.4	\$171.2	\$167.0	\$187.7	\$671.3	\$709.0	\$749.2
Selling, general and administrative expense	\$224.0	\$250.4	\$243.8	\$249.3	\$62.0	\$58.3	\$56.5	\$60.6	\$237.4	\$237.1	\$247.4
EBITDA	\$353.8	\$388.3	\$412.7	\$432.6	\$83.4	\$112.9	\$110.5	\$127.1	\$433.9	\$471.9	\$501.8
Depreciation	\$86.7	\$95.7	\$108.8	\$100.4	\$23.7	\$23.6	\$22.6	\$22.3	\$92.2	\$92.1	\$100.3
EBITA	\$267.1	\$292.6	\$303.9	\$332.2	\$59.7	\$89.3	\$87.9	\$104.8	\$341.6	\$379.8	\$401.4
Interest and other income (expense), net	(\$165.5)	(\$183.2)	(\$203.3)	(\$163.4)	(\$35.5)	(\$23.9)	(\$23.0)	(\$23.0)	(\$105.4)	(\$102.2)	(\$102.7)
Pretax income	\$101.6	\$109.4	\$100.6	\$168.9	\$24.2	\$65.4	\$64.9	\$81.8	\$236.2	\$277.6	\$298.7
Income tax expense	\$27.7	\$28.2	\$18.3	\$26.5	\$10.8	\$9.5	\$7.3	\$9.4	\$37.0	\$47.2	\$67.9
Adjusted Net Income	\$73.9	\$81.2	\$82.3	\$142.4	\$13.4	\$55.9	\$57.6	\$72.4	\$199.2	\$230.4	\$230.9
Minority Interest	\$3.9	\$1.2	(\$0.1)	(\$1.0)	(\$0.4)	(\$0.5)	(\$0.7)	(\$0.7)	(\$2.3)	(\$3.4)	(\$4.3)
Nonrecurring items	(82.0)	(58.1)	(81.1)	(57.9)	(\$46.8)	(\$11.2)	(\$10.4)	(\$3.2)	(71.6)	(0.4)	(4.4)
Tax adjustment	3.9	11.7	(8.7)	(23.0)	\$24.8	\$13.6	(\$3.9)	\$3.4	37.9	(0.1)	(1.0)
Nonrecurring items (net of tax)	(78.1)	(46.4)	(89.8)	(81.0)	(\$22.0)	\$2.4	(\$14.3)	\$0.2	(33.7)	(0.3)	(3.4)
Net income from continuing operations (GAAP)	(29.1)	2.1	(50.9)	18.0	(\$20.3)	\$46.2	\$30.8	\$61.4	118.1	181.3	173.0
Income from Discontinued Operations	21.0	41.3	(1.2)	2.7	(\$0.4)	\$0.2	\$0.0	\$0.5	0.3	2.0	0.0
Net income	(\$50.1)	(\$39.2)	(\$49.7)	\$15.3	(\$19.9)	\$46.0	\$30.8	\$60.9	\$117.8	\$179.3	\$173.0
EPS (excl. nonrecurring items, incl. options beg Q105)	\$0.99	\$1.09	\$1.10	\$1.89	\$0.13	\$0.44	\$0.46	\$0.55	\$1.63	\$1.77	\$1.80
EPS (as reported)	(\$0.67)	(\$0.52)	(\$0.66)	\$0.20	(\$0.19)	\$0.37	\$0.24	\$0.46	\$0.96	\$1.38	\$1.35
Calendar EPS	\$1.20	\$0.80	\$1.25	\$2.10					\$1.67	\$1.94	\$1.83
Weighted average shares outstanding (diluted)	74.8	74.8	74.8	75.2	105.5	126.0	126.3	131.0	122.2	129.9	128.0
MARGIN ANALYSIS:											
Gross profit	37.7%	37.7%	36.5%	37.31%	34.8%	37.6%	37.4%	37.8%	36.9%	38.0%	38.1%
SG&A	14.6%	14.8%	13.5%	13.6%	14.8%	12.8%	12.7%	12.2%	13.1%	12.7%	12.6%
EBITDA	23.1%	22.9%	22.9%	23.7%	19.9%	24.8%	24.7%	25.6%	23.9%	25.3%	25.5%
Depreciation	5.7%	5.6%	6.0%	5.5%	5.7%	5.2%	5.1%	4.5%	5.1%	4.9%	5.1%
Amortization	1.9%	2.0%	2.4%	2.3%	2.7%	2.5%	2.6%	2.1%	2.5%	2.4%	2.5%
Depreciation & amortization	7.5%	7.7%	8.5%	7.8%	8.4%	7.7%	7.7%	6.6%	7.6%	7.4%	7.7%
Operating income	17.4%	17.3%	16.9%	18.2%	14.3%	19.6%	19.7%	21.1%	18.8%	20.3%	20.4%
Tax rate (adjusted)	27.2%	25.8%	18.2%	15.7%	44.6%	14.5%	11.3%	11.5%	15.7%	17.0%	22.7%
Net income	4.8%	4.8%	4.6%	7.8%	3.2%	12.3%	12.9%	14.6%	11.0%	12.3%	11.8%
GROWTH RATES:											
Revenue	3.5%	10.6%	6.2%	1.5%	1.0%	3.43%	-1.4%	-4.4%	-0.6%	2.7%	5.2%
Revenue (excl. foreign exchange effect)			0.0%	2.2%	1.2%	8.3%	7.8%	5.9%	5.9%	6.2%	
Revenue (organic)			6%	2%	1.2%	6.3%	6.8%	5.0%	5.3%	5.9%	5%
Gross profit	12%	11%	3%	4%	6%	5%	-3%	-11%	-2%	6%	6%
SG&A	10%	12%	-3%	2%	13%	-16%	-14%	2%	-5%	0%	4%
EBITDA	12.6%	9.7%	6.3%	4.8%	1.5%	20.9%	4.2%	-15.8%	0.3%	8.8%	6.3%
EBITA	18%	10%	4%	9%	7%	34%	7%	-18%	3%	11%	6%
Net income (excl. non-recurring items)	56.2%	9.9%	1.3%	73.0%	-1024.8%	100.1%	48.0%	-6.0%	39.9%	16%	0.2%
Net income (WB Calculation)	55.6%	7.7%	-8.0%	67.8%	60.9%	159.5%	56.7%	-6.2%	39.9%	17%	7.6%
EPS (excl. non-recurring items, incl. options)	56.2%	9.9%	1.3%	72.2%	-755.5%	18.8%	-12.4%	-45.3%	-13.9%	8.8%	1.7%
Diluted shares outstanding	0%	0%	0%	0%	41%	68%	69%	72%	62.60%	6.3%	-1.45%

Source: Company reports, FactSet, and William Blair & Company, L.L.C. estimates

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DOW JONES: 17,928.20

S&P 500: 2,089.46

NASDAQ: 4,939.33



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	65	Outperform (Buy)	14
Market Perform (Hold)	32	Market Perform (Hold)	2
Underperform (Sell)	2	Underperform (Sell)	0

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