

Catalent

F3Q15 Review: Healthy Quarter Aided by Strong Margins, While Guidance Is Adjusted for FX; Reiterate Overweight

Catalent (CTLT) reported solid F3Q15 results, with revenues in line with Street expectations, driven by strength in Oral Technologies and healthy performance in Development and Clinical Services, while the bottom line beat was driven by strong margins, which benefited from favorable mix (in particular, within the modified release division of Oral Technologies). Not surprisingly, and consistent with a range of other companies recently reporting earnings, management took the opportunity to lower guidance to accommodate an incremental FX headwind since the last update, while the fundamental outlook across core businesses continues to be robust. We maintain our Overweight rating and December 2015 PT of \$35.

- **Solid top line performance driven by Oral Technologies.** F3Q15 revenues of \$447M (+8% cc) came in slightly below consensus (\$453M), but were in line with JPMe (\$447M). By segment, Oral Technologies revenues of \$284M (+10% y/y cc) were driven by strength in Modified Release, due to product participation activities and softgel growth in North America, which helped offset declines in Latin America and APAC. Medication Delivery Solutions (MDS) revenues of \$61M (+2% y/y cc) were driven by strength in biologics and stable performance in Blow-Fill-Seal, which was offset by decreased demand in the European pre-filled syringe operation. Finally, Development and Clinical Services (DCS) revenues of \$104M (+4% y/y cc) were driven by an increase in Analytical Services, due to higher project volumes in the U.S. offset by weakness in comparator sourcing revenues.
- **Adj. EBITDA margins once again come in above expectations.** Moving down the P&L, adj. EBITDA of \$111M (24.7%%) increased significantly y/y and came in above our estimates (\$108M), driven by margin expansion in Oral Technologies (which were up significantly on both a q/q and y/y basis), driven by increased profits from product-participation related activities, coupled with higher revenues from modified release products. DCS margins also improved from last year, driven by the Micron acquisition and cost saving initiatives. Medication Delivery Solutions margins declined, however, due to lower demand and mix within the European pre-filled syringes operation, as well as unfavorable mix in Blow-Fill-Seal. On the bottom line, adj. EPS of \$0.46 also came in above the Street/JPMe of \$0.43/\$0.45.

Catalent (CTLT;CTLT US)

FYE Jun	2014A	2015E (Prev)	2015E (Curr)	2016E
Adjusted EBITDA (\$ mn)				
Q1 (Sep)	82	89A	89A	96
Q2 (Dec)	93	113A	113A	104
Q3 (Mar)	106	108	111A	127
Q4 (Jun)	151	135	126	140
FY	432	440	433	467
Revenue FY (\$ mn)	1,828	1,846	1,817	1,930
Adjusted Diluted EPS FY (\$)	1.83	1.71	1.65	1.78

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 8 for analyst certification and important disclosures.

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Overweight

CTLT, CTLT US

Price: \$29.18

Price Target: \$35.00

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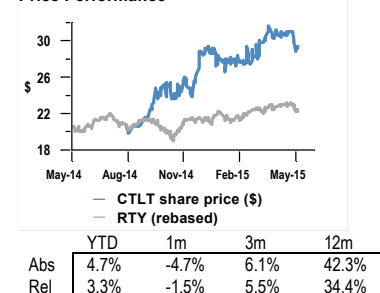
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Price Performance



Company Data

Price (\$)	29.18
Date Of Price	05 May 15
52-week Range (\$)	31.66-19.30
Market Cap (\$ mn)	3,567.73
Fiscal Year End	Jun
Shares O/S (mn)	122
Price Target (\$)	35.00
Price Target End Date	31-Dec-15

- **Leading indicators point to healthy fundamental outlook.** For the Advanced Delivery Technologies business, management noted that the company has introduced 120 new products YTD (flat y/y), with long cycle development revenues coming in at \$97M YTD (+28% y/y). In the DCS business, LTM B2B came in at a healthy 1.1x, with backlog of \$393M, which was up +3% on a sequential basis, pointing to a healthy outlook over the next several quarters.
- **Tuck-in M&A adds differentiated capabilities in key growth areas.** On the call, management highlighted the recent acquisition of Pharmapak Technologies, a pharmaceutical packaging business based in New South Wales, Australia, to complement the existing oral dose facility in Victoria. The company also noted that the integration of Micron Technologies was now “essentially complete”. As a reminder, Micron is a leader in particle size engineering, which should augment capabilities in highly-potent and cytotoxic drug handling, integrated inhalation solutions and analytical lab services, while also positioning CTLT well to partner with biopharma clients earlier in the development cycle. Finally, management once again highlighted the acquisition of a remaining stake in Redwood Bioscience and its differentiated SMARTag Antibody-Drug Conjugate technology platform, which should bode well for CTLT from a competitive standpoint, as it further strengthens the position in a fast-growing, high-margin biologics market, which accounted for ~10% of revenues and continues to outpace pharma in terms of growth (growing 70% YTD). In terms of operating highlights, CTLT noted that it has now completed and opened a large-scale expansion of the Winchester, KY manufacturing facility, which doubles U.S. capacity for Controlled Release.
- **FY15 guidance lowered for incremental FX headwinds, but organic outlook remains robust.** In conjunction with the quarter, management also updated the FY15 outlook for incremental FX headwinds (\$12-16M headwind, with ~2/3 of revenues generated OUS), with the company now forecasting revenues of \$1,800-1,825M (including \$3-5M from recent acquisitions and vs. prior expectations of \$1,820-1,860M) and adj. EBITDA of \$428-436M (including a \$4-8M impact from FX and vs. prior expectations of \$434-444M). Net income is expected to be \$197-205M (vs. the prior forecast of ~\$204-214M), along with capex of \$120-130M (no change). Management attributed the change in guidance largely to incremental strengthening in the USD since the company last updated the outlook, along with modest changes in the base business (namely, changes in end market demand for certain customer products, softness in European CSS, and changes in low margin comparator sourcing). Finally, management continues to expect a weighted average diluted share count of ~122-124M.
- **Updating estimates, reiterate Overweight and December 2015 PT of \$35.** We are encouraged by CTLT’s solid performance this quarter, and are updating our model for commentary from the earnings call and incremental FX headwinds, as we reiterate our Overweight rating. We continue to believe that as a global leader in the drug delivery outsourcing market, Catalent sits at the nexus of several secular trends, including growing demand from biopharma companies for complex dose forms, and low outsourcing penetration rates for drug delivery functions in the 15-30% range (significantly lower than those in the CRO sector). We expect CTLT’s differentiated and diversified operating platform including an end-to-end solution and deep regulatory expertise, coupled with sticky customer relationships, to drive consistent top-line growth with industry-leading margins, with deleveraging and M&A driving HSD EPS growth going forward. We maintain our December 2015 PT of \$35. For further details on our investment thesis, please see our [initiation](#).

Figure 1: CTLT F3Q15 Variance

	3Q14A		3Q15E				3Q15A				Variance		Notes
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.		
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%	
Oral Technologies	287		276				284		-1.1%		8	+10% y/y cc	
Medication Delivery Solutions	65		65				61		-6.4%		(4)	+2% y/y cc	
Developmental & Clinical Services	104		108				104		0.0%		(4)	+4% y/y cc	
Revenue Elimination	(3)		(2)				(2)						
Total Revenue	453		447		453		447		-1.4%		(1)	+8% y/y cc	
Gross Profit	173	38.2%	168	37.5%			173	38.7%	0.0%	57 bp	5	124 bp	
SG&A	(74)	16.3%	(72)	16.0%			(67)	15.1%	-8.7%	-120 bp	4	-93 bp	
Other Operating Expenses	(4)	0.9%	(3)	0.6%			(6)	1.2%	41.0%	37 bp	(3)	63 bp	
Operating Income	60	13.3%	56	12.5%			66	14.7%	9.3%	145 bp	10	219 bp	
Adj. EBITDA	106	23.4%	108	24.3%			111	24.7%	4.2%	135 bp	2	49 bp	
Interest expense	(40)		(21)				(23)		-43.1%		(2)		
Income Tax	(7)	-16.3%	(7)	-31.8%			(11)						
Adjusted Net Income	39	8.6%	58	12.9%			58	12.9%	48%	431 bp	(0)	-5 bp	
Diluted Shares	74.8M		128.5M				126.3M		68.8%		-2.2M		
Adjusted Diluted EPS	\$0.52		\$0.45		\$0.43		\$0.46		-12.3%		\$0.01		

Guidance for FY15

F3Q15 Segment Highlights

- **Revenue:** \$1,800-1,825M [prior: \$1,820-1,860M]
- **Adj. EBITDA:** \$428-436M [prior: \$434-444M]
- **Adj. Net Income:** \$197-205M [prior: \$204-214M]
- Sharecount: 122-124M
- Capex: \$120-130M [no change]

- **Oral Technologies:** Strength in Modified Release and softgel growth in NA helped offset declines in LatAm and APAC
- **MDS:** Strength in Biologics and stable demand in Blow-Fill-Seal offset by weakness in EU pre-filled syringes
- **DCS:** Strong analytical services revenue off higher US project volumes offset by comparator sourcing weakness
DCS backlog: \$393M (+3% q/q), LTM B2B: 1.1x

Source: J.P. Morgan estimates, Company data.

Investment Thesis, Valuation and Risks

Catalent (*Overweight; Price Target: \$35.00*)

Investment Thesis

As a global leader in the drug delivery outsourcing market, Catalent sits at the nexus of several secular trends, including growing demand from biopharma companies for complex dose forms and low outsourcing penetration rates. We expect CTLT's differentiated and diversified operating platform, coupled with sticky customer relationships, to drive consistent top-line growth with industry-leading margins, with deleveraging and M&A driving HSD EPS growth going forward.

Valuation

Our December 2015 DCF-derived price target of \$35 assumes a CAPM-derived WACC discount rate of 7.8% and 1.5% terminal growth.

Risks to Rating and Price Target

Risks to our Overweight rating include: (1) product and regulatory risk is inherent to the industry and business model (legal and reputational costs depending on the severity of the issue, supervision from the FDA, etc.); (2) biopharma consolidation and R&D budget cuts; and (3) capital allocation (risk from value-destructive deals, disruption to the core business model, etc.).

Figure 2: CCTL Model

Income Statement				F1QA	F2QA	F3QA	F4QA			F1QA	F2QA	F3QA	F4QE			CAGR	
USD \$M	F2012A	F2013A	Sep	Dec	Mar	Jun	F2014A	Sep	Dec	Mar	Jun	F2015E	F2016E	F2017E	F2018E	'12-15	'15-20
Oral Technologies	1,220	1,186	259	286	287	348	1,180	261	277	284	332	1,155	1,217	1,274	1,333	-1.8%	4.7%
Medication Delivery Solutions	224	219	57	55	65	69	246	57	74	61	65	257	270	281	294	4.7%	4.4%
Developmental & Clinical Services	268	405	101	102	104	105	412	103	108	104	101	416	453	485	520	15.7%	7.5%
Total Revenue	1,695	1,800	414	441	453	520	1,828	418	456	447	496	1,817	1,930	2,030	2,136	2.3%	5.3%
Cost of Goods Sold	1,056	1,145	274	282	280	309	1,145	272	278	274	305	1,129	1,198	1,259	1,324		
Adj. Gross Profit	639	656	140	159	173	211	682	146	177	173	191	688	732	771	812	2.5%	5.5%
Adj. SG&A	299	275	65	71	74	65	276	68	74	67	75	284	300	305	310	-1.7%	2.3%
Adjusted EBITDA	388	413	82	93	106	151	432	83	113	111	126	433	467	500	534	3.7%	7.1%
Other Income (Expense)	179	228	40	40	46	48	174	77	20	24	18	139	69	68	68		
GAAP Pre-Tax Income	19	(24)	(5)	4	15	53	67	(34)	42	42	56	106	198	234	270		
Income Taxes	17	24	(7)	23	7	26	50	(14)	(4)	11	10	3	36	60	84		
GAAP Net Income	(40)	(47)	1	(19)	7	27	16	(20)	47	32	47	105	165	176	189		
Adjusted Net Income	39	84	(2)	28	38	77	141	14	56	58	75	204	237	248	261		
Diluted Shares Outstanding	0.0	0.0	74.8	74.8	74.8	76.1	76.1	105.5	126.0	126.3	131.3	122.3	131.5	131.9	132.3		
EPS - GAAP			0.02	(0.25)	0.11	0.35	0.20	(0.19)	0.37	0.24	0.35	0.77	1.23	1.31	1.41	N/A	18.4%
Adjusted EPS			(\$0.02)	\$0.37	\$0.52	\$1.01	\$1.83	\$0.13	\$0.44	\$0.46	\$0.57	\$1.65	\$1.78	\$1.86	\$1.95	N/A	7.3%
Adj. Gross Margin	37.7%	36.4%	33.8%	36.0%	38.2%	40.6%	37.3%	35.0%	38.9%	38.7%	38.5%	37.9%	37.9%	38.0%	38.0%	0.1%	0.1%
change in gross margin (y/y, bp)	+0	-128	+15	-123	+245	+200	+93	+124	+293	+57	-209	+53	+8	+5	+3		
Adjusted SG&A	17.6%	15.3%	15.8%	16.2%	16.3%	12.5%	15.1%	16.2%	16.3%	15.1%	15.1%	15.6%	15.5%	15.0%	14.5%		
Adj. EBITDA Margin	22.9%	22.9%	19.8%	21.2%	23.4%	29.0%	23.7%	19.9%	24.8%	24.7%	25.4%	23.8%	24.2%	24.6%	25.0%	1.3%	1.6%
Tax Rate	88.7%	-100.8%	137.5%	529.5%	45.2%	49.2%	73.4%	40.8%	-9.7%	26.7%	18.0%	3.1%	18.0%	25.8%	31.0%		
Adj. Net Margin	4.8%	4.6%	-0.4%	6.3%	8.6%	14.8%	7.8%	3.2%	12.3%	12.9%	15.0%	11.1%	12.1%	12.1%	12.1%	32.2%	3.6%
Reported Revenue Growth y/y	5.1%	6.2%	0.6%	1.1%	1.4%	2.9%	1.5%	1.0%	3.4%	-1.4%	-4.5%	-0.6%	6.2%	5.2%	5.2%		
EBITDA Growth y/y	9.8%	6.3%	-0.1%	-8.2%	5.4%	17.6%	4.7%	1.5%	20.9%	4.2%	-16.3%	0.2%	7.8%	7.0%	6.9%		

Source: J.P. Morgan estimates, Company data.

Figure 3: CTLT DCF Analysis

Target Period:	Dec 2015											
Projected FY Ending Dec	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Revenue (\$M)	1,828	1,817	1,930	2,030	2,136	2,244	2,358	2,475	2,596	2,721	2,849	2,982
growth y/y		-1%	6%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBIT (\$M)	289	288	320	355	391	428	468	509	551	596	643	692
EBIT margin	16%	16%	17%	17%	18%	19%	20%	21%	21%	22%	23%	23%
Tax-affected EBIT (\$M)	(160)	241	262	264	270	296	323	351	380	411	444	477
Free Cash Flow	(129)	210	278	278	278	303	328	355	384	414	447	476
growth y/y			32%	0%	0%	9%	8%	8%	8%	8%	8%	6%

Discount Rate	Discounted Cash Flows (\$M)	PV of Terminal Value (\$M) at a Perpetual Growth Rate of					Enterprise Value (\$M)					Equivalent Terminal EBITDA Multiple (forward 12 mos)				
	2015-2024	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
6.8%	2,374	4,089	4,465	4,912	5,453	6,121	6,463	6,839	7,286	7,827	8,495	7.3x	7.7x	8.2x	8.9x	9.6x
7.3%	2,317	3,623	3,931	4,292	4,722	5,242	5,939	6,248	6,609	7,039	7,559	6.7x	7.1x	7.5x	8.0x	8.6x
7.8%	2,262	3,228	3,483	3,780	4,127	4,540	5,490	5,745	6,041	6,389	6,802	6.2x	6.5x	6.8x	7.2x	7.7x
8.3%	2,209	2,890	3,104	3,350	3,635	3,969	5,099	5,313	5,559	5,843	6,178	5.8x	6.0x	6.3x	6.6x	7.0x
8.8%	2,157	2,600	2,780	2,986	3,222	3,496	4,757	4,938	5,144	5,380	5,654	5.4x	5.6x	5.8x	6.1x	6.4x
	Net Debt (Cash) (\$M)	Equity Value (\$M)					Equity Value per Share					Terminal Value as a % of Enterprise Value				
		0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
	1,740	4,723	5,099	5,546	6,087	6,755	\$38.63	\$41.70	\$45.36	\$49.79	\$55.25	63%	65%	67%	70%	72%
	1,740	4,200	4,508	4,869	5,299	5,819	\$34.35	\$36.87	\$39.82	\$43.34	\$47.59	61%	63%	65%	67%	69%
-	1,740	3,750	4,005	4,302	4,649	5,062	\$30.67	\$32.76	\$35.18	\$38.02	\$41.40	59%	61%	63%	65%	67%
	1,740	3,359	3,573	3,819	4,104	4,438	\$27.48	\$29.23	\$31.23	\$33.56	\$36.30	57%	58%	60%	62%	64%
	1,740	3,017	3,198	3,404	3,640	3,914	\$24.68	\$26.16	\$27.84	\$29.77	\$32.01	55%	56%	58%	60%	62%

Source: J.P. Morgan estimates, Company data.

Catalent: Summary of Financials

Income Statement - Annual	FY14A	FY15E	FY16E	FY17E	Income Statement - Quarterly	1Q15A	2Q15A	3Q15A	4Q15E
Revenues	1,828	1,817	1,930	2,030	Revenues	418A	456A	447A	496
Cost of products sold	(1,229)	(1,215)	(1,286)	(1,346)	Cost of products sold	(293)A	(300)A	(294)A	(328)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(335)	(340)	(358)	(362)	SG&A	(81)A	(88)A	(81)A	(90)
R&D	-	-	-	-	R&D	-	-	-	-
Operating income	241	245	267	301	Operating income	43A	62A	66A	74
EBITDA	374	350	413	446	EBITDA	43A	102A	100A	111
Net interest (income) / expense	(163)	(103)	(81)	(80)	Net interest (income) / expense	(36)A	(24)A	(23)A	(21)
Other income / (expense)	(10)	(36)	12	12	Other income / (expense)	(41)A	4A	(1)A	3
Income taxes	(50)	(3)	(36)	(60)	Income taxes	14A	4A	(11)A	(10)
Net income	140	201	234	245	Net income	13A	56A	58A	74
Diluted shares outstanding	76	122	132	132	Diluted shares outstanding	106A	126A	126A	131
Diluted EPS	0.20	0.84	1.23	1.31	Diluted EPS	(0.19)A	0.37A	0.24A	0.35
Balance Sheet and Cash Flow Data	FY14A	FY15E	FY16E	FY17E	Ratio Analysis	FY14A	FY15E	FY16E	FY17E
Cash and cash equivalents	74	194	369	583	Sales growth	1.5%	(0.6%)	6.2%	5.2%
Accounts receivable	404	380	401	417	EBIT growth	17.9%	1.6%	8.9%	13.1%
Inventories	135	131	136	139	EPS growth	-	(10.3%)	8.1%	4.5%
Other current assets	75	73	73	73	Gross margin	-	-	-	-
Current assets	688	778	979	1,212	EBIT margin	16.3%	18.1%	16.6%	17.5%
PP&E	873	868	879	893	EBITDA margin	23.7%	23.8%	24.2%	24.6%
Total assets	3,090	3,161	3,335	3,548	Tax rate	73.4%	3.1%	18.0%	25.8%
Total debt	2,711	1,934	1,905	1,905	Net margin	7.6%	11.1%	12.1%	12.1%
Total liabilities	3,458	2,574	2,560	2,573	Net Debt / EBITDA	609.8%	401.8%	329.0%	264.7%
Shareholders' equity	(367)	586	775	975	Net Debt / Capital (book)	116.2%	74.8%	66.5%	57.6%
Net income (including charges)	18	103	162	173	Return on assets (ROA)	4.5%	6.4%	7.2%	7.1%
D&A	143	145	147	144	Return on equity (ROE)	(35.9%)	183.9%	34.4%	28.0%
Change in working capital	13	(86)	(11)	(6)	Enterprise value / sales	3.4	2.9	2.6	2.4
Other	5	6	27	27	Enterprise value / EBITDA	14.4	12.3	10.9	9.8
Cash flow from operations	178	167	324	338	Free cash flow yield	1.7%	1.4%	7.0%	7.5%
Capex	(122)	(128)	(120)	(125)					
Free cash flow	39	50	270	290					
Cash flow from investing activities	(171)	(253)	(120)	(125)					
Cash flow from financing activities	(42)	223	(29)	0					
Dividends	0	0	0	0					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Jun

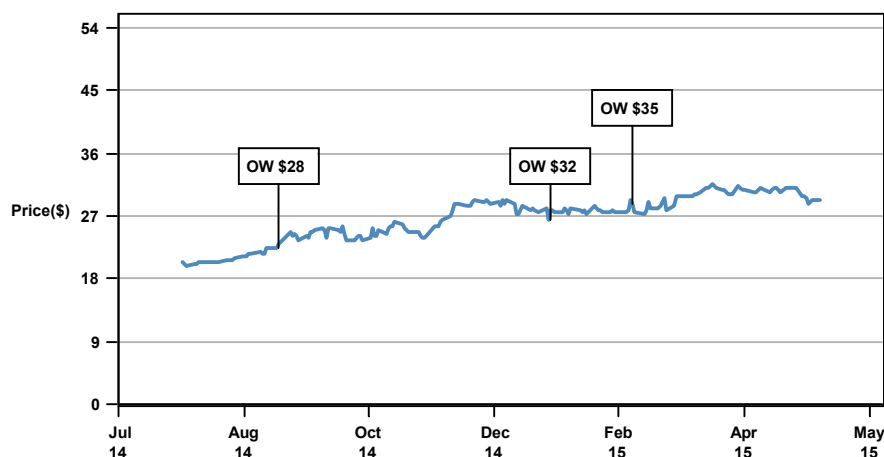
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Catalent (CTLT, CTLT US) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 09, 2014.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

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