

## Catalent

### F2Q15 Review: Quarter Beats Expectations, While Outlook Remains Intact (ex-FX); Reiterate Overweight and Raise PT to \$35

Catalent (CTLT) reported solid F2Q15 results, coming in above Street expectations on both the top and bottom line, driven by strength in Medication Delivery Solutions and healthy performance in Development and Clinical Services. While management lowered guidance to accommodate the significant (albeit anticipated) incremental FX headwind since the last update, the fundamental outlook across the business continues to be robust, and we continue to like the setup for the stock, given that CTLT sits at the nexus of several secular trends, including growing demand from biopharma companies for complex dose forms, and low outsourcing penetration rates. Despite some quarter-to-quarter lumpiness, 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. Reiterate Overweight rating, as we increase our DCF-derived 2015 PT to \$35. For further details on our thesis, please see our [initiation](#).

- **Top line beats consensus driven by MDS...** F2Q15 revenues of \$456M came in above consensus (\$451M) and were in line with JPMe (\$455M). Oral Technologies revenues of \$277M (+3% y/y cc) were driven by strength in Modified Release and softgel growth in Latin America and North America, which helped offset declines in Europe and APAC. Medication Delivery Solutions (MDS) revenues of \$74M (+38% y/y cc) were driven by double-digit growth in Blow-Fill-Seal, along with a sequential recovery in Sterile Injectables, which was partially timing related. Finally, Development and Clinical Services (DCS) revenues of \$108M (+7% y/y cc) were driven by an increase in Analytical Services, due to higher project volumes in U.S. with growth in the integrated oral solids development and supply business.
- **...with adjusted EBITDA significantly above expectations.** Moving down the P&L, adjusted EBITDA of \$113M (24.8%) increased significantly y/y and came in well above (\$96M), driven by strong double-digit margin performance in MDS (up significantly on a q/q and y/y basis), which benefitted from improved product mix in blow-fill-seal, as well as the timing of certain customer orders (pull forward from F3Q). DCS margins also improved over last year off improved product mix within clinical services, while Oral Technologies margin was roughly flat, due to increased profit from CTLT's product-participation related activities and a mix shift towards modified release technologies. On the bottom line, adj. EPS of \$0.44 also came in above the Street/JPMe of \$0.34/\$0.38, driven by the strong margin performance.

#### Catalent (CTLT;CTLT US)

FYE Jun	2014A	2015E (Prev)	2015E (Curr)	2016E (Prev)	2016E (Curr)	2017E (Prev)	2017E (Curr)
EBITDA (\$ mn)							
Q1 (Sep)	82	89A	89A	96	97	113	114
Q2 (Dec)	93	96	113A	104	106	122	124
Q3 (Mar)	106	124	108	134	128	133	127
Q4 (Jun)	151	149	135	153	148	154	149
FY	432	454	440	488	480	522	513
Revenue FY (\$ mn)	1,828	1,904	1,846	2,021	1,960	2,127	2,062
Adjusted Diluted EPS FY (\$)	1.83	1.84	1.71	1.90	1.84	1.98	1.91

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: \$29.32

▲ **Price Target: \$35.00**  
Previous: \$32.00

#### Life Science Tools & Diagnostics

**Tycho W. Peterson** <sup>AC</sup>

(1-212) 622-6568

tycho.peterson@jpmorgan.com

**Bloomberg** JPMA PETERSON <GO>

**Tejas Savant**

(1-212) 622-5650

tejas.savant@jpmorgan.com

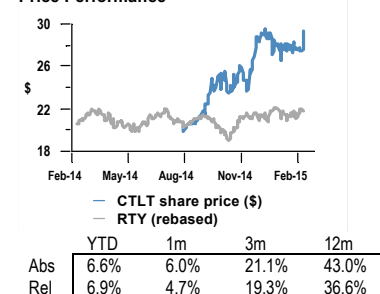
**Patrick Donnelly**

(1-212) 622-9735

patrick.donnelly@jpmorgan.com

J.P. Morgan Securities LLC

#### Price Performance



#### Company Data

Price (\$)	29.32
Date Of Price	11 Feb 15
52-week Range (\$)	30.32-19.30
Market Cap (\$ mn)	3,599.29
Fiscal Year End	Jun
Shares O/S (mn)	123
Price Target (\$)	35.00
Price Target End Date	31-Dec-15

- **Leading indicators continue to suggest a strong FY15 setup.** For the Advanced Delivery Technologies business, management noted that the company has introduced 88 new products YTD (flat y/y), with long-cycle development revenue coming in at \$62M YTD (+32% y/y). In the DCS business, LTM B2B in the business came in at a healthy 1.0x, with backlog of \$381.0M, down -1% on a sequential basis, but pointing to a healthy outlook over the next several quarters. These metrics, while not perfect indicators of future performance, suggest healthy momentum across both ADT and DCS heading into the rest of the year.
- **Recent tuck-in M&A adds differentiated capabilities in key growth areas.** In early October, CTLT acquired the remaining stake in Redwood Bioscience and its differentiated SMARTag Antibody-Drug Conjugate technology platform. Management highlighted that the integration was currently under way and progressing according to plan. CTLT also entered into a collaboration with Sanofi-Aventis to develop ADCs using the SMARTag platform. We continue to believe this deal should bode well for CTLT from a competitive standpoint, as it further strengthens its position in the fast-growing, high-margin biologics market, which accounted for ~10% of revenues and which continues to outpace pharma in terms of growth. The company also completed the acquisition of Micron Technologies, 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 positioning CTLT well to partner with biopharma clients earlier in the development cycle. Finally, the company announced the addition of new coating and blister packaging equipment at the German softgel facility. Looking ahead, management noted that it remains comfortable with a leverage ratio of 5.0-5.5x for the right transformative strategic deals (vs. current levels of 4.1x), as long as it has visibility in bringing down the leverage to 3.5x over time.
- **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 (with roughly two-thirds of revenues generated OUS and a 10-15% weakening of the Euro and GBP vs. the USD since the last quarter), with the company now forecasting revenue of \$1,820-1,860M and adjusted EBITDA of \$434-444M (vs. prior expectations of \$1,890-1,915M with adjusted EBITDA of \$450-460M). Net income is expected to be \$204-214M (vs. prior forecast of ~\$215-225M) along with capex of \$120-130M (vs. prior expectations of \$115-125M). While operational metrics did come in above expectations in the quarter, management noted the significant adverse shift in exchange rates since they last updated their outlook as the sole driver of the downward revision. Finally, interest expense is expected to be ~\$105M, with an effective tax rate of 18% and a weighted average diluted share count of ~122-124M. For F3Q15, management noted that a material pull-forward of certain customer orders into the second quarter would mute the typical seasonal increase that they usually see from F2Q to F3Q.
- **Updating estimates, reiterate Overweight and increase Dec 2015 PT to \$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, and reiterate our Overweight thesis. 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 reiterate our Overweight rating and increase our December 2015 PT to \$35 (vs. our previous PT of \$32). For further details on our investment thesis, please see our recent [initiation](#).

Figure 1: CTLT F2Q15 Variance

	2Q14A		2Q15E				2Q15A				Variance		Notes
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.		
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%	
Oral Technologies	286		295				277		-3.0%		(18)		+3.3% y/y cc
Medication Delivery Solutions	55		57				74		33.3%		17		+38.2% y/y cc
Developmental & Clinical Services	102		106				108		5.6%		2		+7.0% y/y cc
Revenue Elimination	(3)		(3)				(3)						
Total Revenue	441		455		451		456		3.4%		0		
Gross Profit	159	36.0%	165	36.2%			177	38.9%	11.8%	293 bp	13	272 bp	
SG&A	(71)	16.2%	(77)	16.9%			(74)	16.3%	3.9%	7 bp	3	-62 bp	
Other Operating Expenses	(5)	1.2%	(3)	0.8%			(6)	1.2%	3.7%	0 bp	(2)	48 bp	
Operating Income	45	10.1%	48	10.6%			62	13.7%	40.2%	359 bp	14	313 bp	
Adj. EBITDA	93	21.2%	96	21.2%			113	24.8%	20.9%	358 bp	16	359 bp	
Interest expense	(42)		(23)				(24)		-42.4%		(1)		
Income Tax	(23)	-56.1%	(5)	-19.9%			4						
Adjusted Net Income	28	6.3%	47	10.3%			56	12.3%	100%	593 bp	9	201 bp	
Diluted Shares	74.8M		123.6M				126.0M		68.4%		2.4M		
Adjusted Diluted EPS	\$0.37		\$0.38		\$0.34		\$0.44		18.9%		\$0.07		
Guidance for FY15							F2Q15 Segment Highlights						
- Revenue: \$1,820-1,860M [prior: \$1,890-1,915M]							- Oral Technologies: Strength in Modified Release and softgel growth in Americas helped offset declines in Europe and APAC						
- Adj. EBITDA: \$434-444M [prior: \$450-460M]							- MDS: DD growth in Blow-Fill-Seal along with a sequential recovery in Sterile Injectables, that was partially timing related						
- Adj. Net Income: \$204-214M [prior: 215-225M]							- DCS: Strong analytical services revenue off higher US project volumes & growth of their integrated oral solids development and supply business; DCS backlog: \$381.0M (-1% q/q), LTM B2B: 1.0x						
Sharecount: 122-124M													
Capex: \$120-130M [prior: \$115-125M]													

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 8.1% 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: CTLT Model

Income Statement				F1QA	F2QA	F3QA	F4QA			F1QA	F2QA	F3QE	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	276	343	1,157	1,220	1,277	1,337	-1.7%	4.7%
Medication Delivery Solutions	224	219	57	55	65	69	246	57	74	65	72	268	281	293	306	6.1%	4.4%
Developmental & Clinical Services	268	405	101	102	104	105	412	103	108	108	112	430	469	503	538	17.1%	7.5%
<b>Total Revenue</b>	<b>1,695</b>	<b>1,800</b>	<b>414</b>	<b>441</b>	<b>453</b>	<b>520</b>	<b>1,828</b>	<b>418</b>	<b>456</b>	<b>447</b>	<b>524</b>	<b>1,846</b>	<b>1,960</b>	<b>2,062</b>	<b>2,170</b>	<b>2.9%</b>	<b>5.4%</b>
Cost of Goods Sold	1,056	1,145	274	282	280	309	1,145	272	278	280	323	1,152	1,222	1,285	1,351		
Adj. Gross Profit	639	656	140	159	173	211	682	146	177	168	202	694	738	777	819	2.8%	5.5%
Adj. SG&A	299	275	65	71	74	65	276	68	74	72	79	292	304	310	315	-0.7%	2.1%
<b>Adjusted EBITDA</b>	<b>388</b>	<b>413</b>	<b>82</b>	<b>93</b>	<b>106</b>	<b>151</b>	<b>432</b>	<b>83</b>	<b>113</b>	<b>108</b>	<b>135</b>	<b>440</b>	<b>480</b>	<b>513</b>	<b>549</b>	<b>4.2%</b>	<b>7.3%</b>
Other Income (Expense)	179	228	40	40	46	48	174	77	20	19	19	135	77	77	77		
GAAP Pre-Tax Income	19	(24)	(5)	4	15	53	67	(34)	42	38	65	111	208	243	279		
Income Taxes	17	24	(7)	23	7	26	50	(14)	(4)	7	12	1	37	63	87		
GAAP Net Income	(40)	(47)	1	(19)	7	27	16	(20)	47	32	54	113	172	182	195		
Adjusted Net Income	39	84	(2)	28	38	77	141	14	56	60	82	212	244	254	267		
Diluted Shares Outstanding	0.0	0.0	74.8	74.8	74.8	74.8	76.1	105.5	126.0	128.5	131.0	122.8	131.3	131.7	132.1		
EPS - GAAP			0.02	(0.25)	0.11	0.36	0.20	(0.19)	0.37	0.24	0.41	0.83	1.30	1.37	1.46	N/A	17.5%
<b>Adjusted EPS</b>			<b>(\$0.02)</b>	<b>\$0.37</b>	<b>\$0.52</b>	<b>\$1.03</b>	<b>\$1.83</b>	<b>\$0.13</b>	<b>\$0.44</b>	<b>\$0.46</b>	<b>\$0.62</b>	<b>\$1.71</b>	<b>\$1.84</b>	<b>\$1.91</b>	<b>\$2.00</b>	<b>N/A</b>	<b>6.9%</b>
Adj. Gross Margin	37.7%	36.4%	33.8%	36.0%	38.2%	40.6%	37.3%	35.0%	38.9%	37.5%	38.5%	37.6%	37.7%	37.7%	37.7%	-0.1%	0.1%
change in gross margin (y/y, bp)	+0	-128	+15	-123	+245	+200	+93	+124	+293	-67	-209	+24	+8	+5	+3		
Adjusted SG&A	17.6%	15.3%	15.8%	16.2%	16.3%	12.5%	15.1%	16.2%	16.3%	16.0%	15.0%	15.8%	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%	24.3%	25.8%	23.8%	24.5%	24.9%	25.3%	1.3%	1.8%
Tax Rate	88.7%	-100.8%	137.5%	529.5%	45.2%	49.2%	73.4%	40.8%	-9.7%	18.0%	18.0%	0.5%	18.0%	25.9%	31.0%		
Adj. Net Margin	4.8%	4.6%	-0.4%	6.3%	8.6%	14.8%	7.8%	3.2%	12.3%	13.3%	15.5%	11.4%	12.4%	12.2%	12.2%	33.5%	3.1%
Reported Revenue Growth y/y	5.1%	6.2%	0.6%	1.1%	1.4%	2.9%	1.5%	1.0%	3.4%	-1.3%	0.9%	1.0%	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%	2.3%	-10.4%	1.8%	9.0%	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	1,846	1,960	2,062	2,170	2,280	2,396	2,516	2,639	2,767	2,898	3,033
growth y/y		1%	6%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBIT (\$M)	289	297	338	373	409	447	487	528	572	617	665	715
EBIT margin	16%	16%	17%	18%	19%	20%	20%	21%	22%	22%	23%	24%
Tax-affected EBIT (\$M)	(160)	254	277	277	282	308	336	365	395	426	459	493
Free Cash Flow	(129)	228	285	285	284	310	336	364	394	426	460	489
growth y/y			25%	0%	0%	9%	8%	8%	8%	8%	8%	7%

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%
7.1%	2,400	3,900	4,242	4,644	5,126	5,714	6,300	6,641	7,044	7,526	8,113	6.9x	7.3x	7.8x	8.3x	8.9x
7.6%	2,342	3,468	3,750	4,078	4,465	4,929	5,810	6,092	6,420	6,808	7,271	6.4x	6.7x	7.1x	7.5x	8.0x
<b>8.1%</b>	<b>2,287</b>	<b>3,100</b>	<b>3,335</b>	<b>3,606</b>	<b>3,922</b>	<b>4,294</b>	<b>5,387</b>	<b>5,622</b>	<b>5,893</b>	<b>6,209</b>	<b>6,581</b>	<b>5.9x</b>	<b>6.2x</b>	<b>6.5x</b>	<b>6.8x</b>	<b>7.2x</b>
8.6%	2,234	2,783	2,981	3,208	3,468	3,772	5,017	5,215	5,441	5,702	6,006	5.5x	5.7x	6.0x	6.3x	6.6x
9.1%	2,182	2,509	2,678	2,868	3,086	3,337	4,691	4,860	5,051	5,268	5,519	5.2x	5.4x	5.6x	5.8x	6.1x
	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%
	1,602	4,698	5,040	5,442	5,924	6,511	\$38.27	\$41.05	\$44.33	\$48.26	\$53.04	62%	64%	66%	68%	70%
	1,602	4,208	4,490	4,819	5,206	5,669	\$34.28	\$36.58	\$39.25	\$42.41	\$46.18	60%	62%	64%	66%	68%
<b>-</b>	<b>1,602</b>	<b>3,785</b>	<b>4,020</b>	<b>4,291</b>	<b>4,607</b>	<b>4,979</b>	<b>\$30.83</b>	<b>\$32.75</b>	<b>\$34.96</b>	<b>\$37.53</b>	<b>\$40.56</b>	<b>58%</b>	<b>59%</b>	<b>61%</b>	<b>63%</b>	<b>65%</b>
	1,602	3,415	3,613	3,840	4,100	4,404	\$27.82	\$29.44	\$31.28	\$33.40	\$35.87	55%	57%	59%	61%	63%
	1,602	3,090	3,258	3,449	3,666	3,917	\$25.17	\$26.54	\$28.09	\$29.87	\$31.91	53%	55%	57%	59%	60%

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

## Catalent: Summary of Financials

Income Statement - Annual	FY14A	FY15E	FY16E	FY17E	Income Statement - Quarterly	1Q15A	2Q15A	3Q15E	4Q15E
Revenues	1,828	1,846	1,960	2,062	Revenues	418A	456A	447	524
Cost of products sold	(1,229)	(1,238)	(1,308)	(1,370)	Cost of products sold	(293)A	(300)A	(301)	(344)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(335)	(348)	(360)	(365)	SG&A	(81)A	(88)A	(86)	(93)
R&D	-	-	-	-	R&D	-	-	-	-
Operating income	241	247	284	319	Operating income	43A	62A	58	84
EBITDA	374	352	426	460	EBITDA	43A	102A	93	120
Net interest (income) / expense	(163)	(100)	(81)	(81)	Net interest (income) / expense	(36)A	(24)A	(20)	(20)
Other income / (expense)	(10)	(36)	4	4	Other income / (expense)	(41)A	4A	1	1
Income taxes	(50)	(1)	(37)	(63)	Income taxes	14A	4A	(7)	(12)
Net income	140	210	242	252	Net income	13A	56A	59	81
Diluted shares outstanding	76	123	131	132	Diluted shares outstanding	106A	126A	129	131
Diluted EPS	0.20	0.90	1.30	1.37	Diluted EPS	(0.19)A	0.37A	0.24	0.41
Balance Sheet and Cash Flow Data	FY14A	FY15E	FY16E	FY17E	Ratio Analysis	FY14A	FY15E	FY16E	FY17E
Cash and cash equivalents	74	215	420	634	Sales growth	1.5%	1.0%	6.2%	5.2%
Accounts receivable	404	402	423	440	EBIT growth	17.9%	2.5%	15.1%	12.4%
Inventories	135	137	143	146	EPS growth	-	(6.6%)	7.7%	3.6%
Other current assets	75	81	81	81	Gross margin	-	-	-	-
Current assets	688	835	1,068	1,301	EBIT margin	16.3%	18.1%	17.2%	18.1%
PP&E	873	859	873	889	EBITDA margin	23.7%	23.8%	24.5%	24.9%
Total assets	3,090	3,145	3,358	3,578	Tax rate	73.4%	0.5%	18.0%	25.9%
Total debt	2,711	1,817	1,817	1,817	Net margin	7.6%	11.4%	12.4%	12.2%
Total liabilities	3,458	2,486	2,502	2,515	Net Debt / EBITDA	609.8%	364.1%	291.3%	230.6%
Shareholders' equity	(367)	659	856	1,063	Net Debt / Capital (book)	116.2%	70.8%	62.0%	52.7%
Net income (including charges)	18	111	170	180	Return on assets (ROA)	4.5%	6.7%	7.4%	7.3%
D&A	143	143	142	140	Return on equity (ROE)	(35.9%)	144.1%	32.0%	26.2%
Change in working capital	13	(77)	(12)	(7)	Enterprise value / sales	3.3	2.7	2.5	2.2
Other	5	21	27	27	Enterprise value / EBITDA	14.0	11.4	10.1	9.0
Cash flow from operations	178	198	327	340	Free cash flow yield	1.7%	2.6%	7.1%	7.5%
Capex	(122)	(117)	(122)	(126)					
Free cash flow	39	92	272	291					
Cash flow from investing activities	(171)	(130)	(122)	(126)					
Cash flow from financing activities	(42)	87	0	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

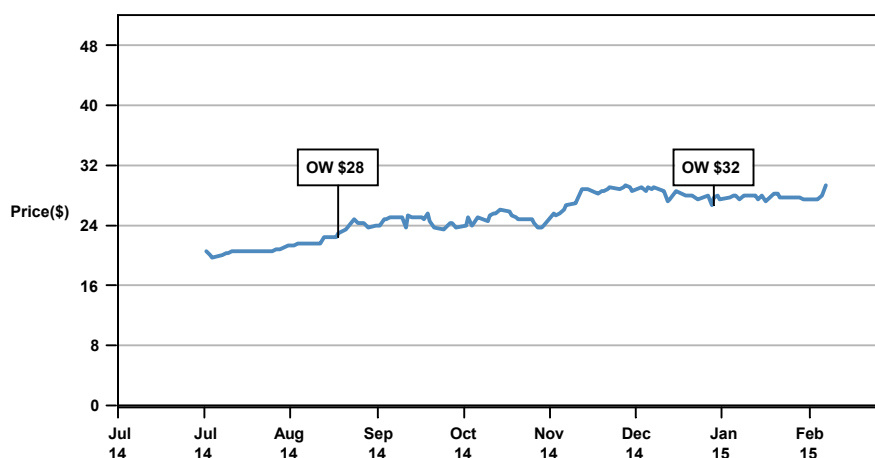
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Catalent (CTLT, CTLT US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
09-Sep-14	OW	22.50	28.00
06-Jan-15	OW	26.55	32.00

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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