

## Catalent

### F1Q15 Review: FY15 Off to a Solid Start; Reiterate Overweight, PT \$28

Catalent (CTLT) reported solid F1Q15 results, with revenues coming in above Street expectations off broad-based strength in Advanced Delivery Technologies, as well as Development and Clinical Services. Importantly, the company also maintained the prior FY15 outlook, despite incremental FX headwinds since it first provided guidance on the F4Q14 call, testimony to overall momentum across the portfolio. Looking ahead, 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. As such, with little to change our investment thesis coming off the strong F1Q15 results, we reiterate our Overweight rating and DCF-derived 2015 PT of \$28. For further details on our thesis, please see our [initiation](#).

- **Solid top-line performance out of the gate...** F1Q15 revenues of \$418M came in above both consensus (\$411M) and JPMe (\$414M). By division, Oral Technologies revenues of \$261M (+1.5% y/y cc) saw strength in Modified Release and softgel growth in APAC (China and Japan), which helped offset an expected decline in prescription softgel volumes in North America. Medication Delivery Solutions (MDS) revenues of \$57M (+1% y/y cc) were driven by increased demand for Blow-Fill-Seal, offset by a y/y decrease in Sterile Injectables, due to flu volume declines. Finally, Development and Clinical Services (DCS) revenues of \$103M (-1% y/y cc) declined as softness in Clinical Services was only partially offset by Analytical Services, which saw higher project volumes in the U.S. and growth of the integrated oral solids development and supply business.
- **...with adj. EBITDA above expectations and debt pay-down timing (not operational issues) explaining the EPS miss.** Moving down the P&L, adj. EBITDA of \$83M (19.9%) was roughly flat y/y and slightly above JPMe (\$82M), with strong double digit margin performance in MDS and DCS, as improved product mix helped offset a slight y/y decline in Oral Technologies, due to lower utilization rates off softer softgel volumes and mix shift towards Consumer Health. On the bottom line, adjusted EPS of \$0.13 came in below the Street/JPMe of \$0.20/\$0.19, with the miss driven mainly by higher interest expense, due to a slight delay related to debt pay down during the quarter.

#### Catalent (CTLT;CTLT US)

FYE Jun	2014A	2015E (Prev)	2015E (Curr)	2016E (Prev)	2016E (Curr)	2017E
Adjusted EBITDA (\$ mn)						
FY	432	454	454	483	488	522
Revenue FY (\$ mn)	1,828	1,899	1,904	2,017	2,021	2,127
Adjusted Diluted EPS FY (\$)	1.83	1.72	1.84	1.91	1.90	1.98

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

## Overweight

CTLT, CTLT US

Price: \$23.81

Price Target: \$28.00

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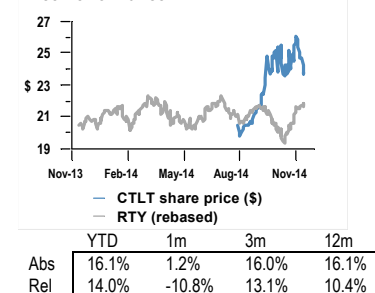
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#### Price Performance



#### Company Data

Price (\$)	23.81
Date Of Price	13 Nov 14
52-week Range (\$)	26.34-19.30
Market Cap (\$ mn)	2,840.74
Fiscal Year End	Jun
Shares O/S (mn)	119
Price Target (\$)	28.00
Price Target End Date	31-Dec-15

#### See page 8 for analyst certification and important disclosures.

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- **Leading indicators point to strong FY15 setup.** For Advanced Delivery Technologies, CTLT has introduced 48 products YTD (+20% y/y), with long cycle development revenues of \$27M YTD (+4% y/y). In DCS, LTM B2B was 1.19, with backlog of \$389.6M, +4% q/q, suggesting healthy momentum across both ADT and DCS heading into 2015.
- **Tuck-in M&A adds differentiated capabilities in key growth markets to the portfolio.** In early October, CTLT acquired the remaining stake in Redwood Bioscience and its differentiated SMARTag Antibody-Drug Conjugate technology platform. While the deal itself was not surprising, given the historical collaboration between Catalent and Redwood, and the pre-existing equity stake, it should bode well from a competitive standpoint, as it further strengthens CTLT's 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. In conjunction with F1Q results, the company also announced the acquisition of Micron Technologies, a leader in particle size engineering (with a portfolio that includes particle size reduction, micronization and milling technologies), 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 and offer a broader set of options. Micron has ~100 employees and currently supports active programs with +300 customers. Management remains comfortable with a leverage ratio of 5.0-5.5x for the right strategic deals (vs. current levels of 4.0x).
- **2015 guidance reiterated despite incremental currency headwinds.** In conjunction with the quarter, management also reiterated the FY2015 outlook, continuing to expect revenue of \$1,890-1,915M with adj. EBITDA in the \$450-460M range. Net income is expected to be ~\$215-225M along with capex of \$115-125M. While operational metrics did come in slightly above expectations in the quarter, management noted the significant adverse shift in exchange rates since the company provided fiscal 2015 guidance on the F1Q14 call, suggesting that strength in the underlying business was sufficient to negate incremental currency headwinds. Finally, interest expense is expected to be ~\$105M, with an effective tax rate of 18% and a weighted average diluted share count of ~119M.
- **Updating estimates, reiterate Overweight and Dec 2015 PT of \$28.** We are encouraged by CTLT's solid performance this quarter and are updating our model for commentary from the earnings call, as we 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. Our December 2015 PT of \$28 remains unchanged. For further details on our investment thesis, please see our recent [initiation](#).

Figure 1: CTLT F1Q15 Variance

	1Q14A		1Q15E				1Q15A				Variance		Notes
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.		
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%	
Oral Technologies	259		259				261		0.8%		2		+1.5% y/y cc
Medication Delivery Solutions	57		57				57		0.7%		0		+0.7% y/y cc
Developmental & Clinical Services	101		101				103		2.1%		2		-0.7% y/y cc
Revenue Elimination	(2)		(3)				(3)						
Total Revenue	414		414		411		418		1.0%		5		
Gross Profit	140	33.8%	141	34.0%			146	35.0%	4.7%	124 bp	6	102 bp	
SG&A	(65)	15.8%	(68)	16.5%			(68)	16.2%	3.4%	38 bp	1	-34 bp	
Other Operating Expenses	(3)	0.7%	(5)	1.1%			(1)	0.3%	-53.3%	-39 bp	3	-81 bp	
Operating Income	35	8.5%	31	7.5%			43	10.2%	21.1%	169 bp	12	268 bp	
Adj. EBITDA	82	19.8%	82	19.9%			83	19.9%	1.5%	10 bp	1	8 bp	
Interest expense	(41)		(31)				(36)		-13.2%		(4)		Higher interest expense due to timing of debt paydown
Income Tax	7	16.1%	(0)	18.0%			14						
Adjusted Net Income	(2)	-0.4%	21	5.1%			13	3.2%	-993%	357 bp	(8)	-186 bp	
Diluted Shares	74.8M		108.4M				105.5M		41.1%		-2.8M		
Adjusted Diluted EPS	-\$0.02		\$0.19		\$0.20		\$0.13		-733.2%		-\$0.07		
Guidance for FY15													
F1Q15 Highlights													
- Revenue: \$1,890-1,915M [no change]													
- Oral Tehcnologies: Modified release strength helped offset Softgel weakness off Rx N.America volumes													
- Medication Delivery Solutions: Blow-Fill-Seal strength offset sterile injectable weakness due to flu volume declines													
- Adj. EBITDA: \$450-460M [no change]													
- Development and clinical Services: Strong analytical services revenue offset weakness in Clinical Services													
DCS backlog: \$389.6M (+4% q/q), LTM B2B: 1.19x													
- Adj. Net Income: \$215-225M [no change]													
- Acquisitions: Remaining stake in Redwood Biosciences (ADC technology for biologics); Micron													

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

## Investment Thesis, Valuation and Risks

### Catalent (*Overweight; Price Target: \$28.00*)

#### 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 \$28 assumes a CAPM-derived WACC discount rate of 9.6% and 1.5% terminal growth. On a relative basis, Catalent currently trades at a CY2015E EV/EBITDA multiple of ~11x, roughly in line versus West Pharma at 10.5x and Quintiles and ~11x. On a 2015E P/E basis, the company trades at 12x, a significant discount to the peer group average of ~18.5x, as a result of more modest (but arguably stable) top-line growth expectations and the significant amount of leverage on its balance sheet. We believe that as the company continues to demonstrate stable top-line growth and sustains/modestly grows its industry-leading EBITDA margins while using FCF to pay down debt, this valuation discount will likely narrow over time. As such, our price target of \$28 implies a 2015 P/E multiple of ~15x, representing a 19% discount relative to the same peer group.

#### 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	F2QE	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	295	298	365	1,219	1,285	1,346	1,409	0.0%	4.7%
Medication Delivery Solutions	224	219	57	55	65	69	246	57	57	67	71	252	264	275	287	3.9%	4.5%
Developmental & Clinical Services	268	405	101	102	104	105	412	103	106	115	118	442	483	517	554	18.1%	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>455</b>	<b>478</b>	<b>552</b>	<b>1,904</b>	<b>2,021</b>	<b>2,127</b>	<b>2,239</b>	<b>3.9%</b>	<b>5.4%</b>
Cost of Goods Sold	1,056	1,145	274	282	280	309	1,145	272	291	294	336	1,193	1,266	1,331	1,400		
Adj. Gross Profit	639	656	140	159	173	211	682	146	165	184	215	710	756	797	839	3.6%	5.5%
Adj. SG&A	299	275	65	71	74	65	276	68	77	72	80	297	313	319	325	-0.2%	2.4%
<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>96</b>	<b>124</b>	<b>149</b>	<b>454</b>	<b>488</b>	<b>522</b>	<b>559</b>	<b>5.3%</b>	<b>7.0%</b>
Other Income (Expense)	179	228	40	40	46	48	174	77	23	23	23	145	91	91	91		
GAAP Pre-Tax Income	19	(24)	(5)	4	15	53	67	(34)	25	50	76	117	201	237	275		
Income Taxes	17	24	(7)	23	7	26	50	(14)	5	9	14	13	36	62	85		
GAAP Net Income	(40)	(47)	1	(19)	7	27	16	(20)	21	42	62	106	166	176	191		
Adjusted Net Income	39	84	(2)	28	38	77	141	14	47	70	90	221	238	248	263		
Diluted Shares Outstanding	0.0	0.0	74.8	74.8	74.8	74.8	76.1	105.5	123.6	123.9	124.2	119.3	124.5	124.9	125.3		
EPS - GAAP			0.02	(0.25)	0.11	0.36	0.20	(0.19)	0.17	0.33	0.50	0.81	1.32	1.40	1.51	N/A	19.2%
<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>\$0.38</b>	<b>\$0.56</b>	<b>\$0.72</b>	<b>\$1.84</b>	<b>\$1.90</b>	<b>\$1.98</b>	<b>\$2.09</b>	<b>N/A</b>	<b>6.5%</b>
Adj. Gross Margin	37.7%	36.4%	33.8%	36.0%	38.2%	40.6%	37.3%	35.0%	36.2%	38.4%	39.1%	37.3%	37.4%	37.4%	37.5%	-0.3%	0.1%
change in gross margin (y/y, bp)	+0	-128	+15	-123	+245	+200	+93	+124	+21	+23	-154	-2	+8	+5	+3		
Adjusted SG&A	17.6%	15.3%	15.8%	16.2%	16.3%	12.5%	15.1%	16.2%	16.9%	15.1%	14.5%	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%	21.2%	26.0%	27.1%	23.8%	24.1%	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%	18.0%	18.0%	18.0%	11.3%	18.0%	26.3%	31.0%		
Adj. Net Margin	4.8%	4.6%	-0.4%	6.3%	8.6%	14.8%	7.8%	3.2%	10.3%	14.5%	16.3%	11.5%	11.7%	11.6%	11.7%	34.0%	2.2%
Reported Revenue Growth y/y	5.1%	6.2%	0.6%	1.1%	1.4%	2.9%	1.5%	1.0%	3.4%	5.5%	6.2%	4.2%	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%	3.3%	17.4%	-0.9%	5.0%	7.6%	7.1%	7.0%		

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

Figure 3: CTLT DCF Analysis

Projected FY Ending Dec	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Revenue (\$M)	1,828	1,904	2,021	2,127	2,239	2,352	2,472	2,596	2,723	2,855	2,990	3,129
growth y/y		4%	6%	5%	5%	5%	5%	5%	5%	5%	5%	5%
EBIT (\$M)	289	309	346	382	420	459	500	543	588	635	684	736
EBIT margin	16%	16%	17%	18%	19%	20%	20%	21%	22%	22%	23%	24%
Tax-affected EBIT (\$M)	(160)	242	283	283	290	317	345	375	406	438	472	508
<b>Free Cash Flow</b>	<b>(129)</b>	<b>264</b>	<b>295</b>	<b>293</b>	<b>294</b>	<b>321</b>	<b>348</b>	<b>377</b>	<b>408</b>	<b>441</b>	<b>476</b>	<b>507</b>
growth y/y			12%	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%
8.7%	2,303	2,839	3,039	3,268	3,531	3,836	5,141	5,342	5,571	5,833	6,139	5.5x	5.8x	6.0x	6.3x	6.6x
9.2%	2,250	2,561	2,731	2,924	3,144	3,397	4,810	4,981	5,174	5,394	5,646	5.2x	5.4x	5.6x	5.8x	6.1x
<b>9.7%</b>	<b>2,199</b>	<b>2,318</b>	<b>2,464</b>	<b>2,628</b>	<b>2,814</b>	<b>3,025</b>	<b>4,516</b>	<b>4,663</b>	<b>4,827</b>	<b>5,012</b>	<b>5,224</b>	<b>4.9x</b>	<b>5.0x</b>	<b>5.2x</b>	<b>5.4x</b>	<b>5.6x</b>
10.2%	2,149	2,105	2,231	2,371	2,529	2,708	4,254	4,380	4,521	4,678	4,857	4.6x	4.7x	4.9x	5.0x	5.2x
10.7%	2,101	1,917	2,026	2,147	2,283	2,435	4,018	4,128	4,249	4,384	4,536	4.3x	4.5x	4.6x	4.7x	4.9x
	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%
	1,465	3,677	3,877	4,106	4,369	4,674	\$30.82	\$32.50	\$34.41	\$36.62	\$39.18	55%	57%	59%	61%	62%
	1,465	3,345	3,516	3,709	3,929	4,181	\$28.04	\$29.47	\$31.09	\$32.93	\$35.05	53%	55%	57%	58%	60%
	<b>1,465</b>	<b>3,051</b>	<b>3,198</b>	<b>3,362</b>	<b>3,547</b>	<b>3,759</b>	<b>\$25.58</b>	<b>\$26.80</b>	<b>\$28.18</b>	<b>\$29.73</b>	<b>\$31.50</b>	<b>51%</b>	<b>53%</b>	<b>54%</b>	<b>56%</b>	<b>58%</b>
	1,465	2,789	2,915	3,056	3,213	3,392	\$23.38	\$24.43	\$25.61	\$26.93	\$28.43	49%	51%	52%	54%	56%
	1,465	2,553	2,663	2,784	2,919	3,071	\$21.40	\$22.32	\$23.33	\$24.47	\$25.74	48%	49%	51%	52%	54%

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

## Catalent: Summary of Financials

Income Statement - Annual	FY14A	FY15E	FY16E	FY17E	Income Statement - Quarterly	1Q15A	2Q15E	3Q15E	4Q15E
Revenues	1,828	1,904	2,021	2,127	Revenues	418A	455	478	552
Cost of products sold	(1,229)	(1,280)	(1,352)	(1,416)	Cost of products sold	(293)A	(313)	(316)	(358)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(335)	(353)	(370)	(375)	SG&A	(81)A	(91)	(86)	(94)
R&D	-	-	-	-	R&D	-	-	-	-
Operating income	241	262	292	329	Operating income	43A	48	73	98
EBITDA	374	365	434	469	EBITDA	43A	84	109	134
Net interest (income) / expense	(163)	(104)	(91)	(91)	Net interest (income) / expense	(36)A	(23)	(23)	(23)
Other income / (expense)	(10)	(41)	0	0	Other income / (expense)	(41)A	0	0	0
Income taxes	(50)	(13)	(36)	(62)	Income taxes	14A	(5)	(9)	(14)
Net income	140	219	237	247	Net income	13A	47	69	90
Diluted shares outstanding	76	119	124	125	Diluted shares outstanding	106A	124	124	124
Diluted EPS	0.20	0.87	1.32	1.40	Diluted EPS	(0.19)A	0.17	0.33	0.50
Balance Sheet and Cash Flow Data	FY14A	FY15E	FY16E	FY17E	Ratio Analysis	FY14A	FY15E	FY16E	FY17E
Cash and cash equivalents	74	490	693	904	Sales growth	1.5%	4.2%	6.2%	5.2%
Accounts receivable	404	423	445	463	EBIT growth	17.9%	8.9%	11.3%	12.5%
Inventories	135	143	151	154	EPS growth	-	0.3%	3.3%	4.0%
Other current assets	75	75	75	75	Gross margin	-	-	-	-
Current assets	688	1,130	1,364	1,596	EBIT margin	16.3%	18.4%	17.1%	18.0%
PP&E	873	878	888	900	EBITDA margin	23.7%	23.8%	24.1%	24.6%
Total assets	3,090	3,502	3,713	3,928	Tax rate	73.4%	11.3%	18.0%	26.3%
Total debt	2,711	1,955	1,955	1,955	Net margin	7.6%	11.5%	11.7%	11.6%
Total liabilities	3,458	2,719	2,738	2,752	Net Debt / EBITDA	609.8%	322.9%	258.7%	201.2%
Shareholders' equity	(367)	783	974	1,176	Net Debt / Capital (book)	116.2%	65.2%	56.4%	47.2%
Net income (including charges)	18	104	165	175	Return on assets (ROA)	4.5%	6.7%	6.6%	6.5%
D&A	143	145	142	140	Return on equity (ROE)	(35.9%)	105.6%	26.9%	22.9%
Change in working capital	13	(10)	(12)	(7)	Enterprise value / sales	2.9	2.2	2.0	1.8
Other	5	44	27	27	Enterprise value / EBITDA	12.3	9.1	8.1	7.1
Cash flow from operations	178	284	322	335	Free cash flow yield	2.1%	6.4%	9.4%	10.1%
Capex	(122)	(114)	(119)	(123)					
Free cash flow	39	182	278	299					
Cash flow from investing activities	(171)	(114)	(119)	(123)					
Cash flow from financing activities	(42)	247	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

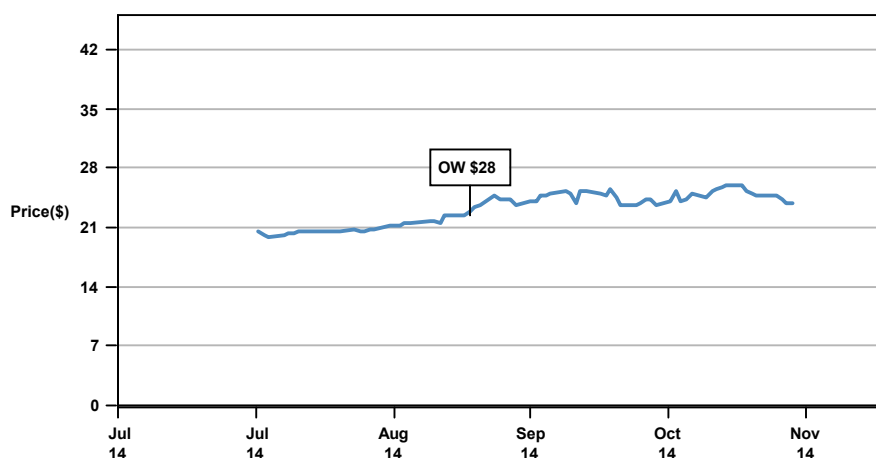
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Catalent (CTLT, CTLT US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
09-Sep-14	OW	22.48	28.00

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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