

Valuation Waterfall

Revenue Growth

Declines in the HCV business – presently Gilead’s largest franchise proportionally – will dominate revenue growth in both best and worst cases. Worst case assumes no super-blockbuster in the next five years; Best case assumes one. If one comes, we believe it will be in the treatment of hepatitis b.

Profitability

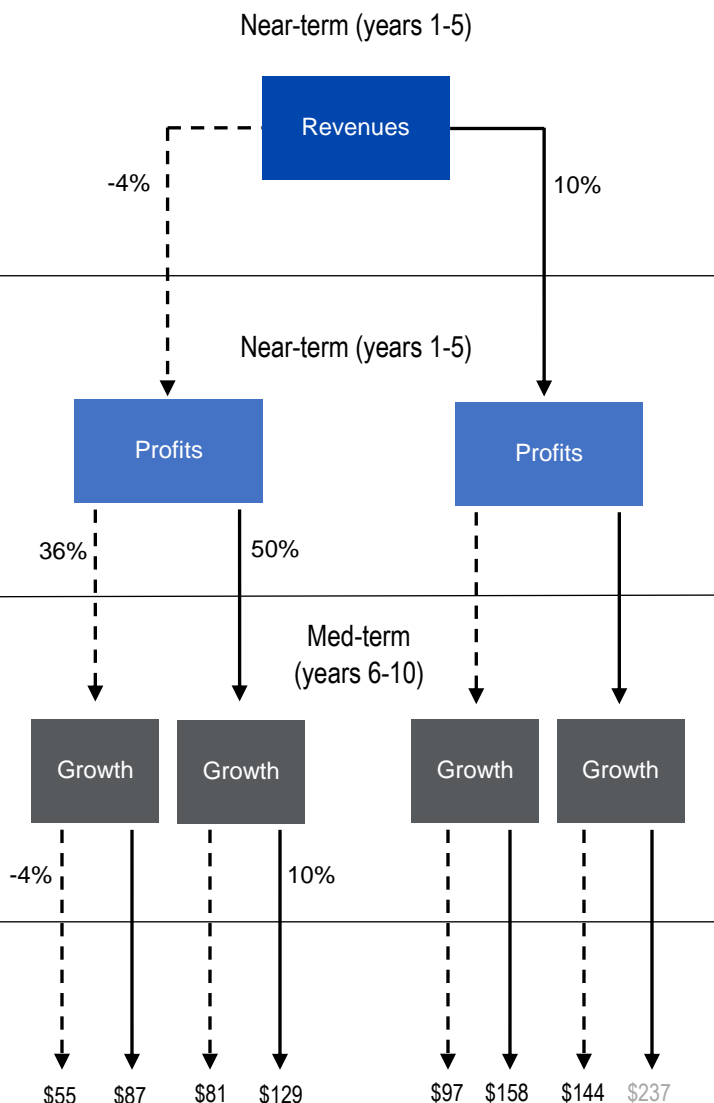
We believe profitability is more likely to be near the 50% best-case level than near the 33% worst-case one, but issues of regulation and competition make this hard to handicap. 33% was the average Owners’ Cash Profit (OCP) margin in the five years between 2009-2013 – just before the HCV franchise took off.

Medium-Term Cash Flow Growth

For medium-term growth to average 10% per year, the company will likely need to develop and market another super-blockbuster during years 6-10. If it cannot, Free Cash Flow to Owners (FCFO) is likely to fall as its drugs mature and competition heats up. We think two super-blockbuster drugs in 10 years is very unlikely.

Fair Value Range

Our fair value range extends from \$55 to \$158 / share and excludes the most extreme valuation scenario. We believe the present stock price reflects the market’s opinion that 1) near-term revenues are likely to fall, 2) near-term profitability is likely to be high, and 3) the firm is unlikely to develop a super-blockbuster in the 5 years starting in 2021.



Methodology

IOI analyses focus on three main valuation drivers: revenue growth, profitability, and medium-term cash flow growth. We estimate a best- and worst-case scenario for each of these drivers resulting in a total of $2^3 = 8$ fair value scenarios based on discounted cash flow methodology. Profitability is measured by Owners’ Cash Profit (OCP) margin. We use a discount rate of 10% for large capitalization stocks.

A wide spread of lowest and highest fair values indicates a firm whose value is uncertain. Risk depends on the stock price’s relationship to the valuation range.

Best-case scenarios are represented with a solid line; worst-case scenarios, with a dotted one.