GILEAD SCIENCES, INC.

Gilead to AZN – Unlikely! Not Now, Not at This Price, Not Ever?

- **Bottom Line:** this weekend Bloomberg and other media sources reported that AstraZeneca (AZN, OP) had made informal overtures to Gilead Sciences about a merger of the two companies. The reports suggested that Gilead engaged advisors to assist in their response to these overtures, before AZN made a statement on Sunday night dismissing these suggestions. We believe such overtures are unlikely to have been received positively by Gilead, which presumably was behind AZN’s “no deal” statement. In this note we outline the reasons why we believe Gilead is unlikely to respond positively to such overtures, whether from AZN or any other party. Gilead’s fortunes are improving, investor sentiment is positive, management is new, fresh and energized, and the company’s operating and strategic performance has been strong. Most large biopharma deals arise from a position of distress, not strength, and Gilead today is far from distressed. From a biopharma industry point of view, it may suggest that AZN is looking to leverage its valuation and current strategic position by making a large acquisition to diversify away from their dependence on its blockbuster oncology franchise, and add another strong franchise or two that offsets any risk that may emerge now or in the future in the oncology business. Adding more revenue through a lower multiple acquisition, particularly if there are perceived synergies, could offer value for AZN shareholders, and for the target’s shareholders as well. Other targets in biopharma, such as perhaps Biogen (BIIB, OP), Amgen (AMGN, MP) or Alexion (ALXN, OP), may be equally suitable for these purposes, and could prove more amenable to overtures than GILD. Notwithstanding our recent upgrade of Gilead to Outperform, we believe Gilead is unlikely to be responsive to AZN’s outreach, and we outline the reasons in this note.

- **Most Biopharma Transactions Emerge from Distress, not Strength.**

Large (>$30bn) biopharma acquisitions are relatively rare (on average one every 12-18 months), and they tend to emerge from conditions of prolonged distress and dissatisfaction with the direction (and share price returns) for the target company. For example, Celgene and Allergan were sold in the last 24 months, and both followed prolonged underperformance, and growing dissatisfaction with management. We have suggested that other biopharma companies, such as Alexion, could be in or approaching this situation today, but we do not have the impression from investors, or management, that Gilead is in this situation. Gilead’s stock has ranged from $68-84 over the last 3 months during the COVID-19 development, but has increased 18% year-to-date and 16% over the last 15 months since current CEO Dan O’Day was named to his post. Gilead’s board has been very active in replacing management, overseeing the recruitment of effective new leadership in finance, research, clinical development and business development, and this new team is only just finding their stride (having been in place for less than 18 months, and some for less than 6 months). Most assessments of their actions so far have been relatively positive. Revenue for the core (and most important) HIV franchise has, with important strategic and tactical transactions completed with Galapagos, Forty Seven Inc, and now Arcus Therapeutics (RCUS, OP), as well as less significant transactions with oNKo-innate, Second Genome, Teneobio, Carma Biosciences, Nurix,
Goldfinch Bio, and insitro. In total the company has deployed $10.5bn in capital into rebuilding their portfolio in the last 18 months, and some of these opportunities have the potential to create substantial value, if the projects in question proceed to commercialization. The company is in the process of diversifying away from their concentration in antivirals, and has been able to at least maintain industry average profitability despite the increased R&D investment being made in these newly acquired and licensed programs. While we have criticized the company’s R&D productivity in the past, there is no suggestion that the company has an excessively “fat” operating model, or an overhead burden that could easily be eliminated in a restructuring or acquisition. The company has responded rapidly and decisively to the COVID-19 pandemic, and has generally communicated clearly and effectively about their development plans, results and manufacturing capacity. They may be on the verge of having one of the fastest growing products in the industry, if they can successfully establish profitable commercial pricing for remdesivir.

• Few Obvious Synergies Given Gilead’s Efficiency. Gilead has had one of the most efficient operating models in the biopharmaceutical industry, with their total SG&A expenses hovering in the 17-18% range for the last two years. Gilead’s historic R&D ratio has been as low as 9% in 2015, and in recent years has increased to 16-17%. The long term sustainable operating margin for Gilead’s core business is certainly over 50%, and indeed the company’s reported pro forma EBIT margin has been in this range for the last two years, having previously been as high as 73% (2015). At this level, Gilead’s profitability is considerably higher than the average for large pharma companies, and it seems unlikely that AstraZeneca, or any other pharma acquirer, could operate the business more efficiently (and deploy capital to maintain and develop the pipeline).

• Gilead’s Board Unlikely to be Soliciting Interest. While press reports suggested that Gilead had retained advisors in response to AZN’s overture, we very much doubt that Gilead initiated the process, or expressed much interest in such discussions. As noted above, Gilead’s fortunes appear to be improving, and with those improving fortunes, their share price, and earnings and revenue multiples, are increasing. In the last 12 months, the company’s share price has increased by 17%, and their revenue and earnings multiples of FY1 consensus estimates have increased by 15% and 25%, respectively. Not only has the share price responded in the last 12 months, but there are many important projects now underway at Gilead (remdesivir development and commercialization, filgotinib launch, GLPG and RCUS collaborations opt-ins, magrolimab development and accelerated commercialization, further investments in internal and external pipeline). These projects are likely to be consuming management’s attention, and also much of the board’s, and it seems unlikely that with so much going on, and so much promise and potential, the board would put the company into play.

• Gilead’s Management Unlikely to be Looking for Exit. In many cases the outlook for a major transaction comes down to the interests, objectives and personalities of key members of the company’s management team. In some circumstances the management team (usually the CEO) may be very long tenured, or may see the company facing existential threats, and may thus initiate consideration of acquisition opportunities. Such circumstances are rare, particularly in the comfortable (and well compensated) world of biopharma c-suites, and are particularly rare when the management team has only very short (<2-3 years) tenure in their positions. Gilead’s C-suite all have relatively short tenure (CEO – 15 months, CFO – 8 months, CMO – 8 months) and these key executives are only filling out their key direct reports now. Once again, this does not look like a management group eager for an exit through acquisition or merger, particularly when the interested party is a company with the overhead, entrenched leadership and bureaucracy of AZN.

• Gilead’s Position and Portfolio are Improving. While a merger or acquisition might have been an interesting prospect for Gilead six
months ago with the stock in the low $60’s, we believe that the company’s position has improved significantly since then. From December 2018 until February 2020 the company’s stock floundered in the mid to low $60’s, and the portfolio suffered from continued erosion of their once massive HCV franchise, and continuing questions about the competitive risks to their HIV business. This year the company has benefited from better than expected performance of the HIV business (+14% in Q1), stabilization of the HCV franchise (-7% in Q1 compared to -23% for 2019). The company has now announced several well-received business development transactions in oncology (47 Inc and Arcus), and, most importantly, their compound remdesivir has become the first antiviral approved for the treatment of the disease that has upended the global economy, and killed hundreds of thousands of people, COVID19. Gilead’s fortunes are turning around, and the company’s multiple has expanded since the start of February by ~35%. Questions are no longer being raised about the company’s direction or prospects, and remdesivir is on the verge of being considered a major revenue driver for the company.

• **Gilead’s Ownership May Even be of National Importance.** We have often remarked that Gilead is “the most indispensable company” in the biopharma industry. This is because in their relatively short (33 years) history, Gilead has contributed substantively to rendering HIV a chronic disease with normal life expectancy, has led the development of curative medicines for another major infectious disease in hepatitis C, and has now delivered the first truly effective antiviral medicine for SARS-nCoV2. Critics will complain that “they did it by acquisitions”, and it’s true that Gilead’s successes in HIV and HCV were both driven from acquisitions; however, those acquisitions brought key pieces of the puzzle that complemented the existing compounds coming from the company’s own laboratories, and allowed them to develop their remarkable “single tablet regimens” or “fixed dose combinations” for these viral diseases. Given this track record, and the intimate relationship of the US government to the development and purchase of Gilead’s medicines, we would be very surprised if ownership of Gilead was permitted to leave the US. This may sound like heresy to investors and free marketeers, but we live in a rapidly evolving moment of reversing globalization. Domestic R&D and manufacturing capabilities, particularly in healthcare, have never been more important to the national interest, and it is hard to imagine another company with greater importance now, and in recent history, than Gilead. We have no information to suggest that such concerns or influences played a hand in the rejection of AZN’s overture, but we would be surprised if they did not become a consideration, should such a transaction be actively considered.
Disclosures Appendix

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I, Geoffrey C. Porges, MBBS, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

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**Outperform (Buy):** We expect this stock to outperform its benchmark over the next 12 months.

**Market Perform (Hold/Neutral):** We expect this stock to perform in line with its benchmark over the next 12 months.

**Underperform (Sell):** We expect this stock to underperform its benchmark over the next 12 months.

The degree of outperformance or underperformance required to warrant an Outperform or an Underperform rating should be commensurate with the risk profile of the company.

For the purposes of these definitions the relevant benchmark will be the S&P 600® Health Care Index for issuers with a market capitalization of less than $2 billion and the S&P 500® Health Care Index for issuers with a market capitalization over $2 billion.
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