

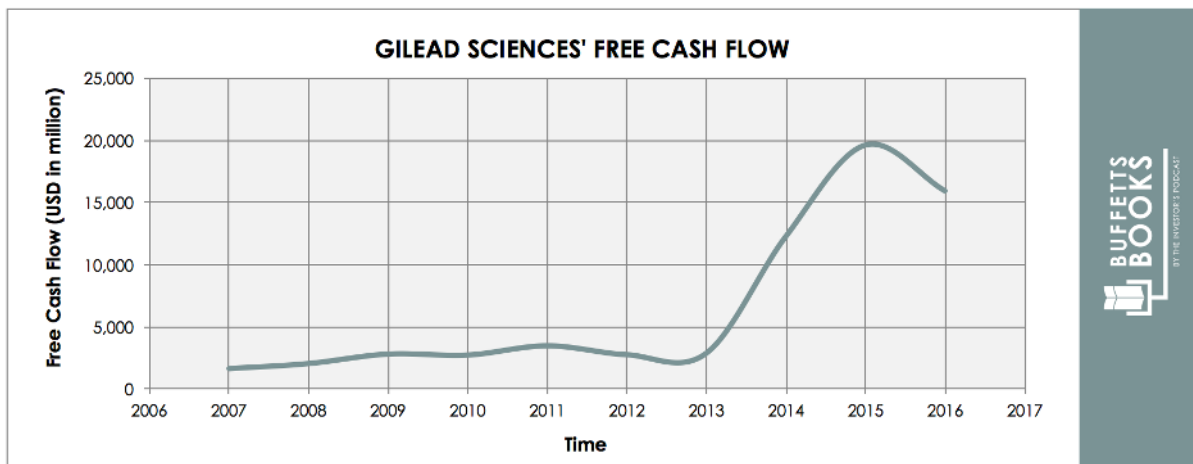
## Introduction

Gilead Sciences is an American based Biopharmaceutical corporation whose principal business involves the discovery, development, and commercialization of pharmaceuticals. Since its founding in 1987, the company has grown to be one of the world's largest biopharmaceutical firms with 9,000 employees across six continents. Gilead Sciences is currently a member of the Fortune 500 list with a market cap of \$95 Billion. Its revenues and free cash flows for the previous financial year were around \$30.4 Billion and \$15.9 Billion respectively. The company's common stock has fluctuated between a low of \$64 and a high of \$86 over the past 52 weeks and currently stands at around \$73. Is Gilead Sciences undervalued at the current price?

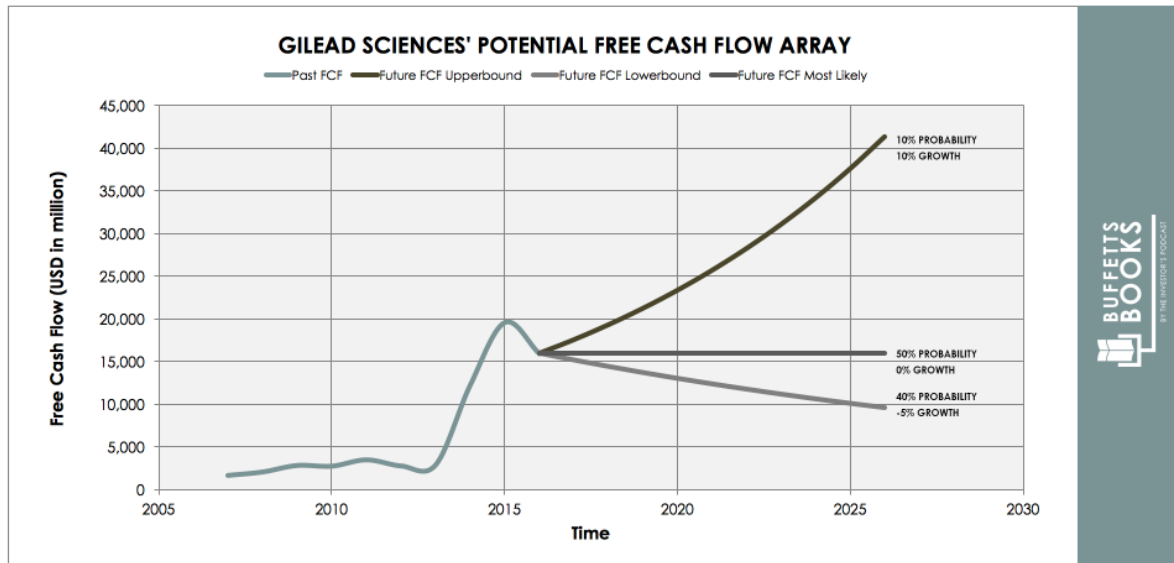


## The Intrinsic Value of Gilead Sciences

To determine the intrinsic value of Gilead Sciences, we will begin by looking at the company's history of free cash flow. A company's free cash flow is the true earnings which management can either reinvest for growth or distribute back to shareholders in the form of dividends and share buybacks. Below is a chart of Gilead Sciences' free cash flow for the past ten years.



As one can see, the company's free cash flow has been on a strong upward trend, growing at an annualized rate of over 28% for the past ten years. Growth has dramatically increased in recent years as its antiviral products sales have soared. In order to determine Gilead Sciences' intrinsic value, an estimate must be made of its potential future free cash flows. To build this estimate, there is an array of potential outcomes for future free cash flows in the graph below.



When examining the array of lines moving into the future, each one represents a certain probability of occurrence. The upper-bound line represents a 6% annualized growth rate, which is based on estimated global pharmaceutical sales from 2016-2022. The author has opted to use this figure as a proxy in lieu of Gilead Sciences' historical growth rates as the company is experiencing sales decline on some of its key products, and the firm's past out-performance may now revert to the mean. This has been assigned a 10% probability of occurrence to account for the possibility that the company may underperform the market over the next decade.

The middle growth line represents a 0% growth rate and assumes that growth stagnates in the coming years as the company's key products are challenged, and pricing pressure squeezes margins. This has been assigned a 50% probability of occurrence as there is currently uncertainty as to whether the firm's triple-combination HIV treatment, a potential \$5 Billion annual revenue stream, will receive approval by the FDA.

The lower bound line represents a -5% growth rate in free cash flow growth and has been assigned a 40% probability of occurrence. This lower bound rate assumes that the company fails to secure approval for its new HIV treatment products and that both increased competition and the loss of patent protection on key products leads to a decline in market share. Assuming these potential outcomes and corresponding cash flows are accurately represented, Gilead Sciences might be priced at a 15% annualized return if the company can be purchased at today's price. We will now look at another valuation metric to see if it corresponds to this estimate.

Based upon Gilead Sciences' current earnings yield, which is the inverse of its EV/EBIT ratio, the company is projected to return around 17%. This is above the firm's 13-year historical median average of 8%, suggesting that the company is undervalued relative to its historical average. Finally, we'll look at Gilead Sciences' EPV (Earnings Power Value), a measure of current free cash flow which assumes no future growth. At present, the company's EPV per share stands at around \$91. This is above the current price per share of around \$73, meaning that the firm is most likely undervalued.

Taking all these points into consideration, it seems reasonable to assume that Gilead Sciences is trading at a discount to fair value at present. Furthermore, the company may return around 15% at the current price if the

estimated free cash flows are achieved. Now, let's discuss how and why these free cash flows could be realized.

## The Competitive Advantage of Gilead Sciences

Gilead Sciences has various competitive advantages outlined below:

- **Intangible Assets.** At present, Gilead Sciences possesses patent protection on many of its products which grants the company pricing power. This pricing power has enabled Gilead Sciences to outperform its peers on a number of performance metrics which can be seen in the table below.

	Gilead Sciences	Industry Average
<b>ROA (ttm)</b>	19.10%	3.70%
<b>ROE (ttm)</b>	55.60%	8%
<b>Operating Margin % (ttm)</b>	57.80%	24.00%
<b>Net Profit Margin % (ttm)</b>	42.20%	14.40%

- **Oligopoly Status.** The Biopharmaceutical Industry is oligopolistic in nature, meaning that a small number of firms dominate the industry and that market share is concentrated in a few hands. Historically, this has resulted in Gilead Sciences Inc. attaining around 80% of the HIV anti-viral market share and 90% of the HCV anti-viral market share. It should be noted that these market shares may decline in the future as competition increases and patent expiration occurs. In fact, this is already occurring for the company's share of the HCV market. Gilead Sciences seems to be taking this issue seriously by developing a pipeline of potential new treatments and making strategic acquisitions to establish a presence in other markets
- **High Barriers to Entry.** New entrants face significant barriers when attempting to enter the Biopharmaceutical Industry as there are substantial regulatory costs and rules to overcome. Large amounts of time and capital are also required in order to successfully bring a product to market. These challenges limit the number of new entrants likely to enter the space and challenge for market share.

## Gilead Sciences' Risks

Now that Gilead Sciences' competitive advantages have been considered, let's look at some of the risk factors which could impair my assumptions of investment return.

- Although Gilead Sciences possesses multiple competitive advantages, there still exists a possibility that one of its rivals could mount a challenge to erode its competitive advantages and move on its market share. It should be noted that some of these competitors, such as GlaxoSmithKline PLC and Merck & Co Inc., possess both their own competitive advantages and ample capital to mount a serious challenge.
- Changes in, or failure to comply with government regulation could materially impact Gilead Sciences' revenues and earnings. The Biopharmaceutical Industry is heavily regulated, and this can both a blessing and a curse. The regulation creates high barriers to entry which limits competition, but it can also result in large financial penalties if companies fail to adhere to it.
- The emergence of a serious economic crisis similar to that witnessed in 2008 could materially impact the company's revenues and profits, leading to lower growth in the coming years. While Gilead

Sciences possesses numerous competitive advantages, a fall in consumer confidence and spending would be detrimental to the company's economic performance.

- Failure to secure approval for new products could be detrimental to Gilead Sciences' economic performance in the coming years. The company will face increasing competitive pressure and patent expiration on its key products going forward and will need to compensate for this by developing new streams of revenue. There is no guarantee that these new products will successfully be brought to market and this must be considered by investors.

### **Opportunity Costs**

Whenever an investment is considered, one must compare it to any alternatives to weigh up the opportunity cost. At present, 10-year treasuries are yielding 2.37%. If we take inflation into account, the real return is likely to be closer to 1%. The S&P 500 Index is currently trading at a Shiller P/E of x 31.4 and, at present, is likely to return around 2-3%. While Gilead Sciences appears to be trading below fair value, offering a higher rate of return than both U.S. Treasuries and the S&P 500, other individual stocks may be found which may offer a more favorable return relative to the risk profile.

### **Macro Factors**

Investors must consider macroeconomic factors that may impact economic and market performance as this could influence investment returns. At present, the S&P is priced at a Shiller P/E of 32.7. This is 94.6% higher than the historical mean average of 16.8, suggesting that markets are at elevated levels. U.S. unemployment figures are at a 30-year low, suggesting that the current business cycle is nearing its peak. U.S. private debt/GDP currently stands at 199.6% and is at its highest point since 2009 when the last financial crisis prompted private sector deleveraging.




### **Summary**


The future for Gilead Sciences looks uncertain at present. The company is currently experiencing some problems which are worth noting. Total revenues for the second quarter of 2017 decreased by 8% to \$7.1 billion from \$7.8 billion for the second quarter of 2016. This is largely a consequence of declining sales of the firm's blockbuster HCV anti-viral products. The company is taking steps to address this issue and is currently seeking FDA approval for its triple-combination HIV treatment, a suite of products that could potentially add \$5 Billion to annual revenues. They have also recently completed a \$12 Billion acquisition of Kite Pharma which may lead to new revenue streams from the lucrative cancer immunotherapies market.

Gilead Sciences is currently carrying meaningful debt relative to its equity with a D/E ratio of 1.1. This is above the industry average of 0.9. The company has used this debt, in part, to fund share buybacks which have lowered the firm's share count by nearly 14% over the last three years. The argument could be made that a more prudent allocation of capital would be to temporarily suspend share buybacks, pay down debt, and accumulate capital for accretive acquisitions. The company does, however, still have a strong liquidity position with a current and quick ratio of 3.68 and 3.39 for the latest quarter.

At present, Gilead Sciences appears undervalued at the current price with a potential return of around 15% annually. This valuation is reliant on Gilead Sciences' ability to produce the free cash flows that were estimated earlier in the article. Although the company's stock price is currently trading at a discount to fair value, there certainly exists a number of risks and uncertainties which must be carefully considered by investors looking to invest in the company.



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