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CSL Limited

Another good result...

Longer-term, CSL has a long runway ahead of them

We are well underway with the 2015 reporting season and Russell Muldoon takes an in-depth look at CSL Limited's half-year result to 31 December 2014. CSL is a global specialty biotechnology company that researches, develops, manufactures and markets products to treat and prevent serious human medical conditions. While the market is focusing on Immunoglobulin, and the potential supply growth from competitors, the story is much bigger than this and it pays to avoid getting too caught-up in the short-term.

CSL Limited (ASX: CSL) is a global specialty biopharmaceutical company that researches, develops, manufactures and markets biotherapies to treat and prevent a range of human medical conditions. CSL is also one of the largest positions held in both The Montgomery Fund and The Montgomery [Private] Fund and here we review the company's half year results.

We describe CSL Limited's (ASX: CSL) half-year result as "solid". The result however 'missed' consensus analyst expectations by 5 to 6 per cent at the Revenue, Earnings Before Interest and Tax (EBIT) and Net Profit After Tax (NPAT) level and so the share price reaction to the result was negative.

- Revenue growth of circa 7 per cent to US$2,849 billion
- NPAT growth of circa 7 per cent (no leverage) to US$692 million
- Earnings Per Share (EPS) growth of circa 9.5 per cent to US$1.45. EPS growth was higher than NPAT growth thanks to CSL's on-going share buyback program.
- In AUD terms, EPS increased to $1.78 +22% (the Australian dollar declined from 89.131c in December 2013 to 81.679c in December 2014)
- All CSL divisions, apart from CSL IP, which can be lumpy, showed growth albeit at declining rates (off higher bases).

CSL's largest business segment, Immunoglobulin (an antibody produced by plasma cells that is used by the immune system to identify and neutralize foreign objects such as bacteria and viruses), is a market growing at 6 to 8 per cent.

Market Concerns

The market had expected a better result after CSL implied strong market growth and a continuation of improving margins.

Even though CSL's half-year volumes were up 11 per cent, suggesting it has been taking market share, revenue growth was just 4 to 5 per cent, implying lower average selling prices.

This failure of revenues to match volumes could indicate that competition is increasing. There has been talk that one of CSL's largest competitors, Baxter International, has additional capacity, which will impact the market with increasing supply.

CSL management mentioned that they are aware of this '*talk*' but are yet to see anything on the ground so "*will see how it goes*". What they do know is that Baxter's new facility in Georgia won't open until 2019 and other attempts to expand production facilities are still plagued with problems, and at a minimum are 18 months behind.

According to Management, there has been no impact. The reason for the lower average selling prices, is as follows:

1) Half of the volume growth reported was in core markets, for example the US, where prices are stable.

2) The balance of the announced growth was in emerging markets where management stated they lowered their average selling prices to acquire market share penetration.

3) CSL are the lowest cost collector and a price leader in production, so this is a well worn path to gaining market share (albeit an obvious negative headwind for margins initially as their sales mix shifts).

4) After gaining acceptance and market share, CSL then sells its portfolio of higher margin specialty products.

We recognize that once in the door, the sales mix will be 40 per cent Immunoglobulin product and 60 per cent specialty products as they penetrate.

We again note Management's comment, "*there is no fundamental shift in the market.*"

An actual headwind we observe is that at CSL's previous full-year result the company announced plans to increase their collection centres' (supply) by 20 per cent to support future demand. This continues, but it will take time to achieve the scale benefits offered by existing centres. The additional costs of running the new centres however will need to be absorbed and this explains why this result saw no benefits from operating leverage.

Currency Concerns

Something else to consider is CSL's exposure to the Swiss Franc. This appears largely responsible for the lowering of NPAT guidance from 12 per cent growth to 10 per cent. On a cash flow basis, CSL have a net-$300 million exposure to Swiss Franc expenses against the USD. The Swiss Franc has appreciated about 10 per cent against the USD, which will add around $30 million in additional costs in future periods. The CFO stated this level of additional expenses, with no revenue offset, would impact earnings to the tune of approximately 2 per cent.

Of course, with the Australian dollar now at US77 cents, some if not all of the adverse impact on CSL's earnings from Swiss Franc appreciation, will be offset for Australian shareholders by the weaker Australian dollar against the USD.

Currently, the market is focusing on Immunoglobulin, the potential impact of Baxter's increasing supply, and currency exposure. But CSL enjoys a much bigger thematic and we should avoid getting too caught-up in the short-term machinations.

CSL is a business with a long runway ahead, and the wind at its back. In terms of demand growth, product innovation and future business expansion, CSL enjoys much blue sky. CSL has an impressive and broad portfolio of products, which will also be bolstered by their recent acquisition of Novartis' influenza vaccine business unit.

At this stage we can't see any reason for major changes to our base-case valuation, which remains at circa $85.00 to $86.00.

CSL | **CSL Limited 2015 HY Result** | **11/2/15**

All amounts are in USD, reported figures

	1H13	1H14	1H15	1H14 Growth	1H15 Growth	Trend
Immunoglobulin	$912,000	$1,085,000	$1,122,000	19.0%	3.4%	
Albumin	$163,000	$313,000	$358,000	92.0%	14.4%	
Haemophillia	$542,000	$550,000	$558,000	1.5%	1.5%	
Specialty	$345,000	$403,000	$443,000	16.8%	9.9%	
CSL Behring	$1,962,000	$2,351,000	$2,481,000	19.8%	5.5%	
bioCSL	$518,000	$217,000	$276,000	-58.1%	27.2%	
CSL IP	$72,000	$101,000	$92,000	40.3%	-8.9%	
Total Revenue	**$2,552,000**	**$2,669,000**	**$2,849,000**	4.6%	6.7%	
Growth		4.6%	6.7%			
Expenses	$1,747,500	$1,840,300	$1,963,400			
Net Interest	-$26,100	-$26,300	-$28,600			
PBT	$778,400	$802,400	$857,000			
Tax	-$151,500	-$156,700	-$164,800			
Tax Rate	-19%	-20%	-19%			
Earnings	**$626,900**	**$645,700**	**$692,200**			
Growth		3.0%	7.2%			
EPS	1.25	1.33	1.45			
		6.7%	9.4%			
Operating CF		$512,500	$656,000			
CFR		79%	95%			
Net Acquisitions		-$170,400	-$161,300			
Other		-$18,600	-$15,500			
Investing CF		-$189,000	-$176,800			
Buybacks		-$241,700	-$164,000			
Other		-$144,600	$251,800			
Financing CF		-$386,300	$87,800			
Shares on Issue (m)	502,870,390	485,354,422	475,767,765			
Buyback impact		-3.5%	-2.0%			