GlaxoSmithKline

Interview with Simon Dingemans, Chief Financial Officer

Goldman Sachs

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Keyur Parekh: Good morning all and thank you for joining us. My name is Keyur Parekh and I cover Glaxo for Goldman Sachs based in the London office.

It has been a pleasure to have you here Simon, so thank you so much for making a trip to be here.

Simon Dingemans: Thank you for having me.

Q. Let me kick off with some - actually do you want to make a few introductory comments on life in the last few months at Glaxo? A lot has been changing, but why don't you start there and then we will pick it up?

A. I think that is a very fair summary because we find ourselves at a point in the execution of the strategy we laid out a number of years ago where the objectives that we described at the time are becoming much more visible, and I think that's really an important measure of how far we have come. The amount of change that we set about to make to the company five, six, seven years ago was really very, very significant given that at the time we had a relatively old pharmaceutical portfolio, we had not launched new products for quite some time and our Vaccines and Consumer businesses were still relatively small.

We did a lot in the 2010-2012 period to grow those organically but there is a limit to how far you can get and equally it takes time to bring new productivity through the R&D pipeline.

So with the Novartis transaction, that really sort of crystallised both the progress that we had made organically but also gave us a chance to significantly reshape the group both in terms of up-weighting Vaccines and Consumer to give us now about 50% of the group with annuity-like businesses that can help balance the risk that inherently sits inside the Pharma business.

That's why we think the structure of the group has merit in that it allows us to offset those different puts and takes, but also allowed us to free up and restructure the Pharmaceutical business ahead of the generitisation of *Advair*. I think I joined the group in 2011 and every meeting since then has been about when it is going to go and we are still talking about it, but it is going to happen at some point and we have been able to reshape the cost base to get more resources behind the new products which you are seeing the evidence of in terms of the transition of that Respiratory portfolio, the growth in HIV and then for the medium and longer term the acceleration of the next waves of the R&D pipeline, whether it's in Oncology or in Immuno-Inflammation.

I think you can see a lot of different moving parts but a lot of change as well and over the last several quarters since we closed the transaction back in March of last year

and described its shape to you in May of last year, we have been very much on track with that execution programme with synergies being delivered on time, slightly under-budget if anything and again feeding the momentum that I have just described. That's probably kind of how we see it sitting here today.

Q. Simon, I want to spend some time talking about the various divisions, but I want to start with the big picture stuff first.

As we look at it from an external observer perspective, it seems like lots of moving parts on a piece of chessboard across the whole industry from a structure perspective, from an M&A perspective. We see Glaxo has kind of done the big transformation over the last 24 months, but I suspect we will observe the rest of the industry shaping up. How do you see the industry structure changing over the next three to five years? Do you think people will go towards the more Glaxo-like model, less pharma-reliant, more annuity-like businesses or do we go down the road of becoming pure play pharma companies? How do you see that?

A. I think it depends on what your proposition to investors really is and to some extent that's coloured by your history, but for us we have always been very clear that we are about balanced growth that can drive operating leverage through the P&L, move earnings per share faster than sales and convert those earnings into cash that we either invest in the business or in M&A or pay a dividend. You can only do that if you have a balanced scale set of businesses. If you are much narrower and you are focussed on a particular area of breakthrough R&D, you are going to think about life very differently, so I think you are going to see two quite different camps. Whether you are at the end of the spectrum where ourselves and, say, J&J might be, you are going to ask very different things of us.

Now, for us that has meant that M&A has been interesting only when it's very, very targeted to bolster the three legs that we have as part of that strategy and those sorts of assets don't come along very often. Big scale M&A at our level has tended historically to actually be very, very disruptive. If you are smaller and you can be more targeted, then there is a genuine place for it, and for us looking forward, depending on what happens in our Oncology and Immuno-Inflammation therapy areas particularly, that's much more where I would expect us to be looking at for M&A going forward, and again, that would be at the smaller scale of things to bolster an effort that we have already got. But until we see the data that we are expecting over the next 12, 18 months, that's hard to call as to whether we have enough by ourselves or whether we need to add to it.

Q. There has also been a lot change as you mentioned in the world of Glaxo. I suspect one of the things that we under-appreciate is the broader cultural change that is ongoing within the company. Half of your Board has changed over the last 15 months.

Just talk us through what has changed from your perspective as a CFO, working for a different Chairman. Is life different?

A. I think you give the credit to the Chairman and he is one of 110,000 people inside the group, so he is obviously influential and he is not the only one who is driving a focus, an increasing focus in performance.

Since I joined, back at the beginning of 2011, there has been a sea-change inside the company in terms of taking it from what historically had been a very regional/federated-type organisation, where if you led a business in France or in Brazil you very much had your own capabilities, your own functions, you

ran a little company of your own, or not so little in some cases. One of the things that Andrew asked me to do when I came on board was really to drive a much more standardised, centralised operating model and maybe we should have been doing it before, but we set about it and five years on I think we have made very significant change there. We are three-quarters of the way through a major upgrade of our IT and systems infrastructure – we now have much more standardised data/language across the company, we use the same metrics, we allocate capital much more rigorously on a CFROI basis; all of that is independently what is happening at the very top level of the company.

I think where you are right in that there is a different style of Chairman, both of them are very hands-on, but both of them are quite different; Chris, a former CEO, Philip used to sit in my sort of chair, so he tends to come out from a very financial lens, Chris came out from a much more operating lens, but both of them are very much in the thick of the business. I actually don't think it is any bad thing to have a fresh pair of eyes looking at the business and asking the obvious "Why do we do it this way?" type questions, and we have had the same from the other refreshed members of the Board that we have had, but that is now settling down.

Very significant – when Andrew announced his retirement back in March - the Board unanimously affirmed the strategy behind the direction that the Group is currently moving in and that is led by Philip and all the new Board members, because they were all identified, other than Vivienne [Cox] at that point. I think there are obviously different perspectives, but you should not assume there is any lack of commitment to the continuity of the principal direction we are going in.

Q. One of the other things that you are going to have to make interesting decisions on, some of them of course not in your hands, is on balance sheet commitment over the next two to three years. Just help us talk through your thought process on your priorities for capital allocation, if there was an option, potentially for the voters to execute the put option, either in '18 or earlier than '18. If you can just talk us through the balance sheet flexibility around that?

A. Okay. There are two important parts there. If you go back to when we closed the Novartis transaction, you will recall that we retained a bigger proportion of the proceeds than we had originally planned to, partly because of some of the currency headwinds and some of the re-pricing of our respiratory business that had gone on during the course of '14, but also, and more importantly, having gone into the businesses, we saw a significant number of opportunities to accelerate the integration and restructuring and get ahead of the curve on the pharma side, but also really drive much greater value more quickly out of the Consumer and Vaccines businesses. That was on the one hand. On the other, we recognise that '15, '16 and '17 in particular is going to be a very significant period of change for the company as we wound down the *Advair* business, if you like, and transferred it across to the new respiratory products. We were changing the mix of the business as I have described, and yet a large number of our shareholders are very focussed on the dividend. We gave a commitment that we would use the capital we had retained, together

with what we generated organically through operations to do two things: accelerate that restructuring and integration and pay a flat dividend over the period of 80p a share ’15, ’16 and ’17, with a view that we would come out of the other side of this bridge period having renewed the business, regenerated the cash generating capability of the new portfolio.

Then the Board, in 2018, can take that on and decide how quickly it wants to grow, what sort of level of cover it wants. It is a bit early to really call that, but we should expect to go back to a more normal period – it is not going to happen overnight - but in the post-2018 era.

Now alongside that we obviously have against us the puts from Pfizer and Shionogi on the HIV business and from Novartis on the Consumer business; Novartis is the biggest piece of it. I am very comfortable the balance sheet can absorb those puts if I am given the opportunity to get hold of them and I think Novartis was here presenting yesterday, so you should probably ask them what they think, but we had a joint venture Board meeting for the Consumer business on Monday morning, before Harry flew out here. We all agreed round the table the business is performing extremely well and we are both in it for the long haul, so it is always their option, but I would personally be very surprised if they came to us in March 2018 when the window opens to say they want to get off the bus that they think is moving very well.

I think you have exactly the same issue with Shionogi where HIV is now 40/50% of their business – why are they going to exit at this point, but they clearly have a choice. Most importantly, I can absorb those; if I take a notch at the long end to do so, I don’t think it will be for very long, given the growth and the cash generation of both of those businesses. We have discussed such with the rating agencies – we have no intention of doing that today, but if that was the price of bringing those business on board, I am a buyer of all three options all day, every day.

Q. Just to be clear, you don’t see pressure on the dividend in ’18 even if those put options were to come to Glaxo?

A. No.

Q. And timing being unclear, but we should be thinking about dividend would then impact to the normal growth pattern as opposed to being flat post-2018?

A. I think again let’s be careful; I am not saying that the dividend will grow again in ’18. I think that in the ’18, ’19 and beyond period you would expect to move back to a more regular growth situation for the dividend. It is likely to take a bit of time, depending on where the Board wants the cover to sit but it will also depend on what other investment opportunities we have.

Q. Let me rephrase my question. You see the growth in cash flow as being enough, dividend cover issues being assigned to support a growing dividend?

A. Yes.

Q. If there are any audience questions, please put your hands up. I want to now focus on the three big businesses but let’s start with Vaccines. You have a couple of big opportunities there with *Shingrix*, but then slightly later on the meningitis vaccines.

Just help us and talk how you think about the pushes and pulls on the margin upside for the business versus driving sustainable revenue growth.

A. Historically our Vaccines business was operating somewhere between a 30-35% operating margin after R&D and there is absolutely nothing that we have seen or found in the Novartis businesses that we have acquired that suggests the combined business can't do that.

Part of our strategy in acquiring the Novartis business was actually to reinforce our ability to stay in that sort of territory by bringing a shift in the portfolio to add more vaccines that were accessible to the US market. Our portfolio historically had been relatively light in the US sales. The meningitis franchise, *Shingrix*, combinations down the track, RSV, GBS, all will have US application and we are working hard to bring and reformulate and reconfigure some of our historic vaccines to also allow them to come to the US.

I think that's probably the right sort of range. That's why we gave a target at the Capital Markets Day last year of plus-30. We are already well on the way. Vaccines is a lumpy business, so quarter-to-quarter you will see the operating margin move around and then we have phasing benefits in Q1 that won't be there in Q2. You should expect the margin to swing from Q1 to Q2 and that's very typical of what you are going to see in this business.

But I think we feel very pleased with the overall shape of what we have now created. We have cleaned up the R&D pipelines to a real best of class selection and are actually very encouraged by the strength of what we saw in Novartis beyond the obvious things that they have been talking about. It has also allowed us to create those three hubs that we have talked about in the US, in Italy and in Belgium, so again diversifying some of our risk there.

And then from a manufacturing perspective, very, very pleased with the quality of what was acquired. Novartis had spent a significant amount of money coming out of their own FDA issues a few years ago and we are now reaping the benefits of that.

We are struggling a bit with *Bexsero* supply because frankly demand has taken off much faster than Novartis ever anticipated. It takes about 18 months to make a dose of *Bexsero*; we can only respond as quickly as we can make it.

Q. I think my daughter is number two on a waiting list somewhere!

Let's as we move forward focus away from Vaccines into Consumer, that's an area where you inherited or you had put together two companies that weren't necessarily on the path of recovery.

Just talk us through how that acceleration of recovery is going, where do you see some of the upsides to margins, be it '16, '17.

A. We started in obviously a very unsatisfactory place in that the Novartis business was still struggling with its 2013 shutdown in Nebraska. It had outsourced a material part of its production and it was very inflexible, and quite frankly it was quite difficult to get it back in. Those Novartis facilities are now back up and running and we are working hard to bring production back in-house so that we don't pay away a margin unless we want to retain a dual source for flexibility reasons.

That was compounded with some much smaller scale and more piecemeal interruptions that we had in our own supply chain but that meant both supply chains were effectively putting a tailwind into 2015 as we combined the businesses.

The disruption of doing so held us back a little bit in the early part of ’15 but I think you could see by the fourth quarter that the integration programme was really beginning to kick in, and then in Q1 we have seen another step forward.

Now some of that is currency, having been against us in ’15 and coming for us into ’16 so far, but underneath it we are still seeing 200 or 300 basis points of movement.

And that’s two things. It’s dropping out a lot of the overlap in the Commercial organisations which tends to be the easiest and shortest-term element to get hold of and now we are also beginning to see procurement, a bit of buying scale supply chain benefits coming through as well as just the leverage of having the top line move. We have cleaned out quite a lot of the inventory that Novartis left us, we’ve harmonised all our commercial practices, we have simplified the distribution network and now there is a lot of momentum there. Emma was at 6% last year, slightly below that in Q1 against a very tough comparator given the *Flonase* launch last year, but I think we are pretty pleased with the momentum we have seen.

Q. I am not looking for specific guidance here, but I was wondering about the shape of the margin curve for the OTC business. Should one think of it is an accelerating curve to the 20% target you have given? Do you see some kind of ebbs and flows and dips along the way?

A. There is definitely going to be some lumpiness, just because as soon as you get into supply chain work then taking facilities offline or rationalising them does cause some interruption. I don’t think it is steady quarter-to-quarter, but the trend I think will be pretty consistent and, if anything, there is probably years one, two and three of the synergy curve against our 2020 target of getting to plus-20, probably seeing a majority of the benefits and then you will see a flattening off in terms of delivery now. That is the plan.

What we generally found in doing previous restructurings is, as you take the layers off you find other areas to go and I am reasonably confident that, particularly in those latter years as we get into the supply chain, that there will be other areas that we can look at, but I think you probably have a curve where you have more of it in those first two or three years and then, as you know, it is banked, and then we get to the difficult question of okay, so where should the margin end-up? Actually most of the peers that we look at are 20 to 25% and you make a trade-off as to what sort of level of growth you want relative to margin? There are obviously a couple that are at top-end of that and they have slightly different business mixes, but let’s get to 20 and then we will decide how we want to invest and how we want to move it forward. Unless we can really change the supply chain in a more fundamental way, getting to the top end of that will just take a bit of time.

Q. Shall we move to ViiV? Clearly an area of phenomenal growth over the last couple of years, but one where you could have increasing competition from Gilead. Just help us think through how you see the portfolio there and the trajectory for growth over the next few years.

A. We are very pleased with the way in which dolutegravir took off as a franchise; whether it is *Tivicay* or *Triumeq* I think the dataset around

dolutegravir was very strong and gave it an immediate impact in a market that, as you say, has historically been very dominated by Gilead.

Gilead are now in the process of launching their own upgrade of their products. Most of what, I think by their own admission, they are delivering is coming out of their own established base and dolutegravir and our product sets around dolutegravir are holdings its own in term of TRx and the underlying trends. There is a bit more volatility, as you would expect, in the NBRx numbers, but I think all credit to the HIV team; they know they are up against someone tough and they have resourced themselves appropriately and they are fighting their own corner.

Then you have to look forward as to where does the market go from here, and our HIV business is obviously taking a slightly different path than Gilead in this, in that we are looking quite actively at whether we should bring forward dual regimens rather than triple regimens. We have also, in the BMS assets that we bought, deepened our pipeline into both long-acting and then rescue treatment and those niche categories where patients have extreme resistance. We are broadening out our footprint, as well as giving us choices in terms of how the market might develop.

I think it is going to get a lot more complicated than just us and Gilead head-to-head and we will see. I would never underestimate Gilead, they are a very tough competitor, but I think so far we have managed to protect our position.

Q. Simon, I am sure you will be pleased you have spent 25 minutes without mentioning *Advair*.

A. Most people normally start with that, but anyway for a change – let's get to it then!

Q. We had Heather Bresch from Mylan here yesterday and they sounded very confident on a first pass approval for *Advair*. I think the GDUFA is March 2017. Just help us think about, from a base planning perspective, should one assume that they get to be AB rated and how should one think about the impact on your margins?

A. I think clearly for us you have to plan on a range of scenarios, from the most pessimistic to the most optimistic. I have certainly heard feedback from her presentation yesterday on her confidence in terms of being approved by the GDUFA date, but let's see. You know, it is not very long ago that you all were telling us that we would never get *Breo* approved on the first pass. These things are complex, they are not white pills and creating genuine comparability and their substitutability is a very technically demanding exercise when you have a device and an inhaled device in particular, so we will see. But even if they do come through we are obviously working hard to make sure that we are positioned, both in *Advair* and the newer products, as best we can to handle that and our greatest focus is in moving as much of the market across onto the newer products. The Salford data that we saw the other day I think gives us some validation of the importance we believe physicians and patients will place on a single device, once-a-day treatment, and the adherence benefits that that gives. I fully acknowledge that payors

don't see it quite so clearly, or certainly are not willing to reimburse us for it, but in the hands of the customer, ultimately at the end of the day, we do think that is going to count for something.

And particularly when you have the *Ellipta* platform across the whole marketplace, so whether you are in monotherapies, dual therapies or triple therapies, you don't have to retrain your patients every single time and that is proving to be quite a material advantage.

So our focus is very much let's move the market to the new products and then the generic argument will become largely one of price and supply. At the sort of RAR rates and discount rates you are seeing in the *Advair* and ICS/LABA market more broadly, you are not very far away from generic pricing already, so there will be a step when it comes but the step is obviously getting smaller each quarter that goes by.

Q. And again given the progress you have made on *Breo* and *Anoro* especially, it has been a very good launch for *Nucala*, the continued strength of the HIV franchise, even if one was to assume a substitutable generic *Advair* in '17, should '17 be a growth year over '16 or should one not think about it from that perspective?

A. I think in pharmaceuticals –

Q. No, for Glaxo.

A. I think that we will give some guidance for 2017 when we get there. Clearly losing *Advair* to a generic, if it went the most conservative view you might have to a typical generic decay curve, then '17 is going to look a lot tougher.

Now there are a lot of questions around whether that is the right decay curve and I think already a number of those trying to bring generic copies of *Advair* into the market indicating supply, price, other issues that they are looking at, so I think this is going to be somewhat less straightforward than *Lipitor* or when other big products have gone.

It is clearly going to be an impact, but I think offsetting that we are still seeing very good momentum in Vaccines and Consumer, HIV, and managing actually the tail of our Pharmaceutical business for what it is as a cash and profit generator also helps contribute. I don't know exactly where we fall but clearly if it goes hard and fast in '17 it is going to slow us significantly and that's why we gave a view back in the Capital Markets Day last year of here we are in '15, here is where we are going to be in 2020. I don't know exactly what happens in '17 and '18 but as we come out the other side, we still have a Respiratory business at least as big as it was then, and we then have virtually no generic exposure for at least five and probably more like eight years. That's a very different position to be in.

Question from the audience: It seems to clearly make sense for the shift that you have had toward the Consumer and the Vaccines portfolio with bringing on more recurring revenue to offset the risks in other parts of your portfolio, but there also has been an enormous amount of emphasis placed on the Oncology side, particularly after ASCO. A lot of the comments out of other competing companies were focussing in that area of course.

Novartis was very proud of its acquisition of your Oncology portfolio, so I wonder if you might talk a little bit about how Oncology fits, where you see your role in the Oncology side of the business going forward.

A. That is a great question because disposing of the marketed Oncology products to Novartis was a key part of unlocking those other two parts of the transaction. I think what we just talked about shows why we are the better owner of those two businesses.

The challenge we had with that Oncology portfolio, it was growing very fast at the time, but they were in many ways already becoming yesterday's news, and even in 2013 I would go to meetings like this and people would say 'Yes, MEK and BRAF, great, but what about the PD-1s?', and the world of that marketplace is moving very, very fast.

Thirdly, you could see the patent lives coming up pretty quickly and we had nothing behind them for about five years in the pipeline at that stage, given that everything we had in the Discovery part of R&D was incredibly early and we really didn't know what we had. So we took the view that if we could get a very big price and at ten times sales I think we got a very big price from someone who could do other things with it that we couldn't on our own, we unlocked the other two pieces, but most importantly we kept that early stage activity and then let's see what we have.

Now, so far the evidence is suggesting we have something pretty interesting. Lots of talk at ASCO I think on the next generation of immuno-oncology treatments, OX40s, ICOS, to pick two candidates that we have, programmes that are looking pretty competitive but again they are Phase I, Phase II-type programmes so it is still early but we are very much in that space. We don't have a PD-1.

We know we had a programme and it failed, so we have moved on to the next generation. Equally epigenetics where with the BET inhibitor we have something that looks potentially quite interesting, so we have potential.

Then the question is, what do you do with it? The other thing that seemed to be coming out of ASCO is a big shift in terms of people looking to partner, create combinations and not necessarily have to own all of those themselves. I think that does actually create a more flexible marketplace for us to try and re-build our business, but we did build our original business from nothing in seven years and it is such a speciality space that if you have the right products and you have the right data and you are genuinely differentiated, then there is a certain pull that allows you to re-establish that position. We can choose to do it with Novartis, we don't have to do it with Novartis, but they are not a bad partner to have if we want to have one, but most importantly, we don't have to do that.

I think what we are really waiting for is over the next 12/18 months, particularly by the end of '17 to just see how those programmes go forward, which ones do we really focus on, because we have a very broad waterfront at the moment, and then we will work out how the commercial infrastructure comes in behind that.

Q. Simon, I think we are running out of time, but I do have one last question for you – actually two last questions for you! One: a prediction on Brexit and secondly, how far does England make it in the Euros?

A. I am not sure either of those are very easy at this point! I am more qualified on the Brexit than the Euros, but anyway!

On Brexit we, as a company, have a very clear view we should stay. The polls are all over the place and they were horribly wrong in the General Election that we had last year and I suspect they are a bit all over the place this year, so I think it is too close to call at this stage. I would hope when people actually get into the ballot box and they think about what the unknown holds or doesn't hold then they will vote to stay. It is a very emotional issue in the UK, but it would be clearly very disruptive.

As for the Euros we normally manage to make it to the quarters or the knock-out stages and then leave everyone wanting for a bit more, so that will probably be my expectation.

Q. Excellent. On that note, Simon, thank you very much for your time and thoughts – appreciated.

A. Not at all, thank you.

[*Ends*]