



This Industry Leader Remains Undervalued

In [May 2017](#), we featured this large-cap biotech stock due to its industry leading position, strong cash flow, and faster growth than traditional pharma. Best of all, the stock's valuation provided significant upside.

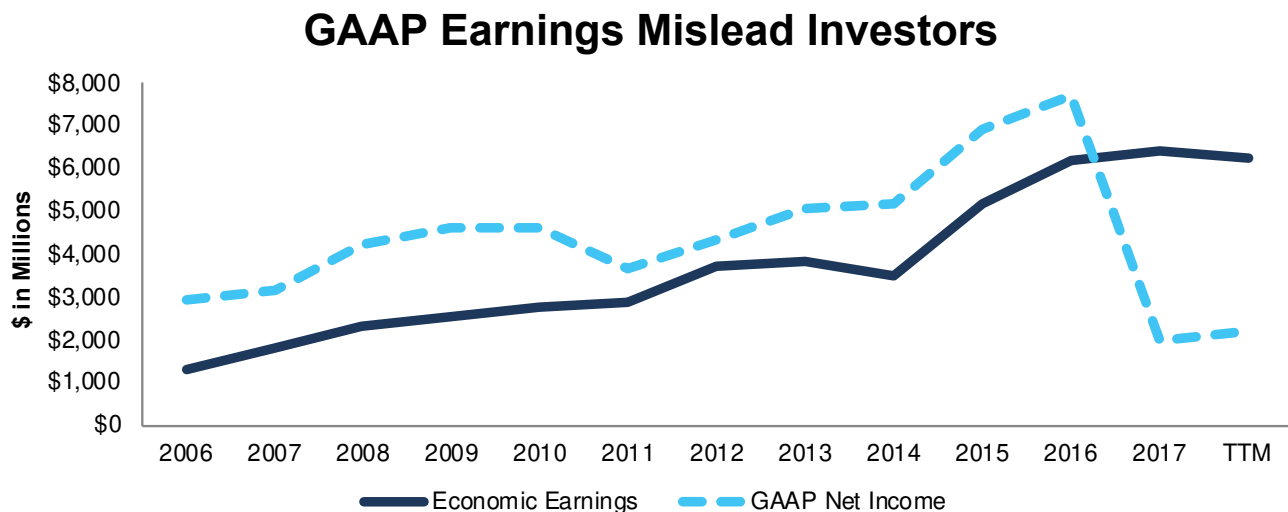
Since then, the stock has more than doubled the performance of the S&P 500 (up 17% vs. S&P up 7%) and helped us earn the [#1 ranking for Healthcare stock pickers on SumZero](#). Now, the stock looks expensive by traditional metrics, but our cash flow adjustments reveal that it's still cheap. [Value investing may be tougher](#), but this stock was and is an excellent value investment. Amgen (AMGN: \$190/share) is this week's [Long Idea](#).

AMGN's Economic Earnings Remain Strong

AMGN has been a profitable and fast-growing company for years, based on any metric. From 2006 to 2016, the company grew GAAP earnings by 10% compounded annually. AMGN's [economic earnings](#) – the true cash flows of the business – grew at an even more impressive 17% compounded annually over that same time.

As Figure 1 shows, however, GAAP earnings declined sharply in 2017 even as economic earnings remained strong.

Figure 1: AMGN GAAP vs. Economic Earnings Since 2006



Sources: New Constructs, LLC and company filings

GAAP earnings significantly understate the company's true profitability for 2017 and the trailing twelve months (TTM) period due to a number of non-recurring expenses. Most notably, the company incurred a \$6.1 billion (26% of revenue) [charge due to the new tax law](#). In addition, AMGN faced \$634 million (3% of revenue) in non-recurring expenses due to [restructuring](#), [damage to one of its facilities from Hurricane Maria](#), and [write-downs](#).

GAAP earnings per share are down 71% TTM. Meanwhile, even though economic earnings are slightly lower TTM than they were in 2017, economic earnings per share are still up 11% year-over-year.



Capital Discipline Rewards Investors

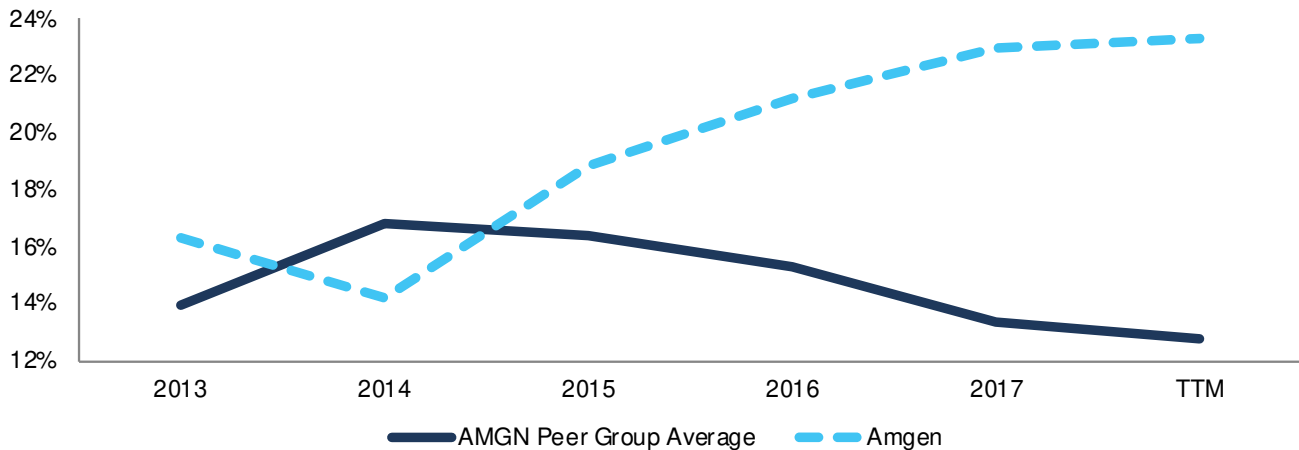
[Income statement adjustments](#) explain most of the difference between AMGN's GAAP net income and economic earnings, but we also need to look at the balance sheet to get the full picture. AMGN has consistently grown net operating profit after tax ([NOPAT](#)) for decades, but over the past few years the company has managed this feat while also reducing its [invested capital](#).

Since 2013 – after AMGN completed its \$9.5 billion acquisition of Onyx – the company has grown NOPAT from \$5.8 billion to \$9 billion TTM (a 55% increase), while decreasing its invested capital from \$47.8 billion in 2013 to \$37.7 billion TTM (a 21% decrease). That decrease in invested capital represents \$10 billion (8% of market cap) in cash freed up to return to shareholders.

The combination of rising NOPAT and declining invested capital means that AMGN's return on invested capital ([ROIC](#)) has risen from 16% in 2013 to 23% TTM. As Figure 2 shows, AMGN's rising ROIC stands in contrast to the [peer group in its proxy statement](#), which has seen ROIC fall since 2013.

Figure 2: AMGN's ROIC Vs. Peers

AMGN Widens ROIC Advantage



Sources: New Constructs, LLC and company filings

Corporate Governance Drives ROIC Advantage

It's no accident that AMGN has outperformed peers in terms of ROIC over the past three years. That outperformance stems from a deliberate decision by the company to prioritize efficient capital allocation and transform itself from a growth-focused company to an efficient, cash generating machine.

When AMGN's compensation committee designed its long-term bonus program for 2017-2019, the company used EPS growth, operating margin, and non-GAAP expense as the target metrics for the first two years. However, in 2019, non-GAAP expense will be replaced with ROIC in order to "support our transformation strategic priority to deliver an efficient, disciplined business model."

This focus on improving ROIC will align the interests of executives and shareholders and ensure prudent stewardship of capital. ROIC is the primary driver of valuation.¹ There is also a strong correlation between [improving ROIC and increasing shareholder value](#), a fact highlighted in our recent article "[CEO's That Focus on ROIC Outperform.](#)"

¹ Ernst & Young's recent white paper, "[Getting ROIC Right](#)", demonstrates the link between an accurate calculation of ROIC and shareholder value.

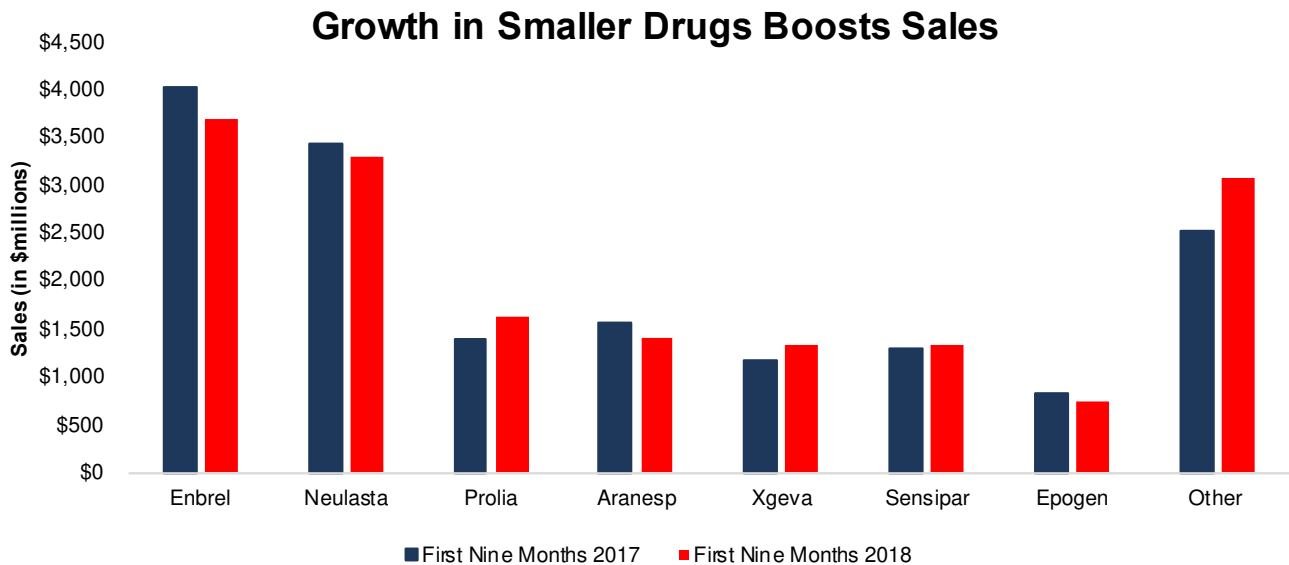


Drug Pipeline Remains Strong

In our original article, we addressed the potential bear case of slowing sales for AMGN’s largest drug, the arthritis treatment *Enbrel*. As it turns out, bears were correct to be worried about *Enbrel*. Sales for the drug are down 8% year over year through the first nine months of 2018. However, overall drug sales are still up 2% year over year.

As Figure 3 shows, several of AMGN’s smaller drugs have risen to offset the decline of *Enbrel*.

Figure 3: Year-Over-Year Sales of AMGN’s Drugs



Sources: New Constructs, LLC and company filings

Osteoporosis treatments *Prolia* and *Xgeva* grew sales by 17% and 12%, while the collection of smaller drugs under the “Other” label are up 22%. Standouts from this group include the cancer treatment *Bincyto* (up 29%) and the cholesterol drug *Repatha* (up 77%).

Offsetting Price Declines with Volume

The high growth of *Repatha* is especially notable since AMGN announced in October that it was [cutting the price of the cholesterol medication by 60%](#). AMGN’s executives weren’t satisfied with the drug’s growth and viewed the price cut as a way to expand the drug’s reach and make its copay more affordable for Medicare patients.

Pricing pressure remains the most significant risk for any company in the biotech/pharmaceutical industry. Competition from generics and the ever-present threat of government regulations put the high industry margins (which typically range from 30-40%) at risk.

Amgen’s superior profitability gives it more flexibility compared to its peers if prices decrease further. The company can afford to lower its prices by a greater amount in order to maintain market share, as evidenced by its move with *Repatha*.

More broadly, Amgen has taken concrete steps to be able to compete in a more price-driven world by developing a portfolio of 10 biosimilars – near-copies of existing products – that could have an addressable market of up to [\\$65 billion](#).

No matter what happens with drug prices, demand will continue to rise. The 65+ population in the U.S. is projected to grow from [~50 million](#) today to [78 million](#) in 2035, and seniors will soon outnumber children. AMGN’s price cuts and investments in biosimilars should enable it to serve a larger portion of this demand and expand its market share to offset potential pricing pressure.



Traditional Value Metrics Mislead Investors

We've recently written about how [price to earnings](#) (P/E) and [price to book](#) (P/B) ratios mislead investors because they rely on flawed GAAP numbers. These ratios are especially misleading for AMGN. As discussed above, non-recurring expenses significantly distort its reported earnings. The company's accounting book value is similarly misleading, as the most valuable asset for any biotech is its intellectual property, which is only carried on the balance sheet if it comes through an acquisition.

When we look at AMGN through the lens of price to economic book value ([PEBV](#)) – which compares the market's valuation of the business to its zero-growth value – and [free cash flow yield](#), we get a much different picture.

Figure 4 compares AMGN to its three largest biotech peers: Gilead (GILD), Biogen (BIIB), and Celgene (CELG). It shows that AMGN has the highest P/E and the second-highest P/B of the group, but it has the second-lowest PEBV and the best free cash flow yield.

Figure 4: AMGN's Valuation Compared to Peers

Ticker	Company Name	P/E	P/B	PEBV	FCF Yield
AMGN	Amgen	59.3	8.4	1.1	8.3%
BIIB	Biogen	20.5	4.6	1.1	6.2%
GILD	Gilead	53.9	3.7	0.7	-5.4%
CELG	Celgene	17.6	9.8	1.3	-10.9%

Sources: New Constructs, LLC and company filings.

When we wrote our original article, AMGN was cheap by both our metrics and traditional metrics, as it had a P/E of 14.3 and a P/B of 3.6. Even though the traditional metrics now look worse, a close examination of the cash flows shows that AMGN is still a value.

Cheap Valuation Creates Potential Upside

At its current valuation of ~\$190/share, AMGN has a PEBV of 1.1. This ratio implies that the market expects the company's NOPAT to grow by no more than 10% for the remainder of its corporate life. For a company that grew NOPAT by 14% compounded annually between 2002-2017, such a low expectation seems overly pessimistic.

Even in the worst-case scenario where pricing pressure drops AMGN's NOPAT margin from 39% down to 24% – in-line with a generic drug producer like Mylan (MYL) – the company can still justify its valuation by growing revenue by 9% compounded annually for a decade. [See the math behind this dynamic DCF scenario.](#)

9% compounded annual revenue growth is ambitious, but not unrealistic for a company that is expanding product lines and taking market share in an already growing industry. AMGN's cheap valuation means that even if bears' worst fears about drug prices come true, the downside is limited.

However, it seems unlikely that such a dramatic decrease in margins is on the horizon. Innovation remains key to improving healthcare outcomes, and that means companies should expect to earn a premium for developing innovative new treatments.

If AMGN's NOPAT margin declines from 39% to 36% (where it was in 2015), and the company grows revenue at 4.5% compounded annually for the next decade (in-line with [projected industry growth](#)), the stock is worth \$226/share today, a 21% upside from the current price. [See the math behind this dynamic DCF scenario.](#)

What Noise Traders Miss with AMGN

In general, markets aren't good at identifying quality capital allocation that creates value and shareholder friendly corporate governance. Instead, due to the [proliferation of noise traders](#), markets are great at amplifying volatility, and therefore risk, in popular momentum stocks, while high-quality unconflicted & comprehensive fundamental research is overlooked. Here's a quick summary for noise traders when analyzing AMGN:

- Transformation from a growth-driven business to a company focused on efficiency and capital allocation, as evidenced by its executive compensation plan.
- Undervalued stock price – AMGN's P/E and P/B ratios look high relative to its peers, but these ratios are misleading.



- Strong drug pipeline to offset decline in top products.

Volume Gains Could Boost Shares

Due to the large amount of media attention given to the price cut for *Repatha*, that drug's performance could have an outsized impact on near-term results. If the drug can reach enough new patients to offset the impact of the price cut, that would send a bullish signal to long-term investors and push shares higher.

In addition, the results of AMGN's biosimilar investments could have a big impact on shares in 2019. We highlighted biosimilars as a potential long-term catalyst in our original article, and now they should start to have a tangible impact on results. The company launched its first two products – *Kanjiti* and *Amgevita* – in Europe in 2018, with eight others set to come in the near future. Strong growth from this new business line could provide earnings beats and stock price appreciation in 2019.

Share Repurchases Plus Dividends Could Provide Upwards of 16% Yield

AMGN has increased its dividend in each of the past seven years. Its annualized dividend has grown from \$1.88/share in 2013 to an announced \$5.80/share in 2019, or 21% compounded annually. The current dividend provides a 2.8% yield. This impressive track record of growth, combined with the company's strong free cash flow, earns it a spot in our [Dividend Growth](#) Model Portfolio.

In addition to dividends, AMGN returns capital to shareholders through share repurchases. Over the past year, AMGN has bought back \$16.5 billion (13.6% of market cap) worth of shares. The company's new commitment to capital discipline means returning more capital to shareholders rather than overinvesting in unprofitable projects. The company's continued growth and investments in biosimilars shows it can grow the business while returning such a large amount of money to shareholders.

Combined with the dividend, AMGN's buybacks give the stock an impressive 16% yield.

Insider Trading and Short Interest Trends

There is little insight to be gained from recent insider trading trends, as they have been minimal. Over the past 12 months, 131 thousand shares have been sold and 211 thousand have been purchased. These purchases represent less than 1% of shares outstanding.

Short interest trends are similarly minimal. There are currently 10 million shares sold short, which equates to 2% of shares outstanding and four days to cover. Short interest has stayed relatively consistent over the past year.

Critical Details Found in Financial Filings by Our [Robo-Analyst Technology](#)

As investors [focus more](#) on fundamental research, research automation technology is needed to analyze all the critical financial [details in financial filings](#). Below are specifics on the adjustments we make based on Robo-Analyst² findings in Amgen's fiscal 2017 10-K:

Income Statement: we made \$7.1 billion of adjustments, with a net effect of removing \$6.9 billion in non-operating expense (30% of revenue). We removed \$110 million in [non-operating income](#) and \$7 billion in [non-operating expenses](#). You can see all the adjustments made to AMGN's income statement [here](#).

Balance Sheet: we made \$48.4 billion of adjustments to calculate invested capital with a net decrease of \$34.3 billion. The most notable adjustment was \$41.4 billion in [excess cash](#). This adjustment represented 58% of reported net assets. You can see all the adjustments made to AMGN's balance sheet [here](#).

Valuation: we made \$81.9 billion of adjustments with a net effect of decreasing shareholder value by \$850 million.

Attractive Funds That Hold AMGN

The following funds receive our Attractive-or-better rating and allocate significantly to AMGN.

1. Live Oak Health Sciences Fund (LOGSX) – 7.7% allocation and Very Attractive rating.
2. White Oak Select Growth Fund (WOGSX) – 6.5% allocation and Attractive rating

² Harvard Business School features the powerful impact of our research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).



3. Smead Value Fund (SVFFX) – 6.3% allocation and Very Attractive rating
4. Invesco Dynamic Pharmaceuticals ETF (PJP) – 5.3% allocation and Very Attractive rating

This article originally published on [December 19, 2018](#).

Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide [tangible, quantifiable correlation](#) to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our [robo-analyst technology](#) empowers us to perform for thousands of stocks, ETFs and mutual funds.



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs. Copyright New Constructs, LLC 2003 through the present date. All rights reserved.