BARCLAYS

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Galapagos: Christmas comes early for GLPG holders - thoughts on the recent outperformance

Stock Rating/Industry View: Overweight/Positive

Price Target: EUR 180.00

Price (12-Dec-2019): EUR 192.25

Potential Upside/Downside: -6%

Both on our recent trip marketing across the US (see: Turkey Trotting round the States (03/12/19)) and since we've gotten back to London, the incoming question we're getting with the highest frequency is what we think could be behind the recent move in GLPG shares. Whilst the local shares have performed better on a relative basis to the SXDP Index vs. the ADRs to the XLV (with some of this likely attributable to a catch-up trade in US biotech, which had lagged the broader indices all year until 4Q), whatever way you want to slice it, GLPG has been a notable outperformer QTD. What makes this move all the more interesting (to us) is that, following a transformative and news-heavy year for the company (with the most notable events begin the FINCH 1 & 3 data publication (see: FINCH results (28/03/19)) and expanded GILD transaction (see: Taking the road less traveled (26/08/19)), the only real fundamental news we have learned this quarter has been fundamentally slightly negative (filgotinib not meeting primary endpoint in ph. 2 studies in Sjogren's and lupus, discontinuation of MOR 106 in atopic dermatitis, futility analysis of ISABLEA trials of GLPG 1690 now coming in 1Q21 vs. prior expectations of sometime in 2020; see Full steam ahead into filgotinib filing (11/11/19) and R&D update (14/11/19)), though we would concede none of these events are necessarily thesis-changing/impactful to NPVs. After speaking to a number of investors on both side of the Atlantic, as well as to the company, we believe there's a number of factors that have been driving the recent move, with no single one necessarily being the most dominant and all probably being partly responsible for the recent move and provide our thoughts below. This by no means an exhaustive exercise, so any incoming thoughts are (as always) welcome.

Our laundry list of explanations…

Addition to MSCI index

In the charts above, we're using October 2nd as our starting point, which was the relative low for GLPG local shares & ADRs post the GILD transaction. We would say that our incomings on GLPG's share price really started going up around the time of the company's 3Q19 report. At that time, the most common rationale given for the outperformance was the addition of Galapagos to the MSCI Global Standard Index, which was effective at the close on November 26th.

Whilst the addition to the index certainly could explain a portion of GLPG's 4Q19 outperformance, we'd note that even after excluding for the day of the index add (when GLPG local shares traded >3.4mm shares), the ADV quarter-to-date remains well of that seen in

other quarters in 2019, which we think lends itself to our second thoughts on GLPG's outperformance…

"Derisking" of the company opening investment up to a wider base

This is an explanation that we've heard throughout the year at times when GLPG has been outperforming, particularly following the readout of the FINCH 1 & 3 data. For many investors, a precommercial biotech company is just viewed as too risky of an investment; however, there's now a particularly clear line of sight into GLPG becoming a commercial company (with filgotinib filed in the EU and US filing immanent, see: Filgotinib will be filed in 2019 (02/07/19)), which can introduce the company to a far wider investor base.

That being said, particularly following the derisking of the MANTA trial as an event that could be an impediment to filing in the US this year, there haven't really been any new developments regarding this narrative, so the question is why such a strong reaction for shares in 4Q19? In our conversations with GLPG, management noted to us that the company has been on the road pretty extensively in recent weeks, particularly following the company's R&D day last month (see: Galapagos: R&D update: still waiting on Toledo but timelines set for ISABELA (14/11/19)), including the company's first extensive roadshow seeing investors in Asia. One thing that we may have underestimated is how much investors also view the expanded GILD deal as a de-risking event in and of itself, which GLPG noted has been a very positive talking point in the company's recent conversations with investors new to the story. After the strong initial post-deal move, those closer to the GLPG story questioned whether shares could sustain the post-deal momentum as this essentially took the upside risk of a takeout off the table; investors newer to the story however view this as a deal that derisks GLPG's pipeline. It will certainly be an interesting exercise to see how the holders list for GLPG changes following 4Q19.

Positive tax implications from GILD deal given Belgian jurisdiction

This is an idiosyncrasy of being domiciled in Belgium that is new information to us. Belgium's tax code has what's called an "Innovation Income Deduction" or IDD which is, for all intents and purposes, a "patent box" intended to encourage local companies to keep IP generated in Belgium domiciled there and thus pay corporate taxes on revenues generated from that IP to Belgium (rather than long-standing historical practice of pharma companies domiciling IP in the US, which has had a lower corporate tax rate). For more background on the IDD, see: BDO: The innovation income deduction - what's new? (20/02/2017)).

Essentially, the impact of this vs. just paying normal corporate taxes (and the corporate tax rate in Belgium is going to be lowered from 33.99% to 29.58% to 25% for assessment years 2019, 2020 and 2021+), is that 85% is removed from the net income taxable base, with the remaining 15% then taxed at the normal corporate tax rate (soon to be 25%); this results in an effective tax rate of 3.75%.

Whilst there has been no formal ruling that all of GLPG's operating income (inclusive of any royalties from GILD) will fall under this scheme, we see a reasonable possibility that it could, which would provide upside to our model. Whilst there's still a lot of uncertainty in modelling when GLPG will be a full corporate tax payer (i.e. the impact of NOLs), we'd assumed that

GLPG's tax rate would eventually creep up to ~20% so anything below that would be upside to our model.

Demand for cash rich biotech vs. debate over cash burn

One other explanation that we've heard that may help explain GLPG's outperformance is that for investors who want exposure in biotech, but may be concerned about potential macro factors (i.e. next year's US election and any drug pricing reform implications), a strong balance sheet can be a particularly attractive feature. And we would note that amongst our other biotech names who've raised capital recently (GMAB with its July US IPO (see: Genmab A/S: COLUMBA filed and sailed the ocean blue (18/07/19)) and argenx's recent capital raise (see: argenx: Thoughts on the capital raise: what's $484mm amongst friends? (07/11/19)), we've also seen pretty strong recent performance.

We think that this factor may be (at the moment) outweighing the downside risk that could come from GLPG burning through its now €5.6bn cash pile faster than the street has modeled. We've heard feedback that at recent investor conferences, GLPG management has noted that it intends to spend all the cash that its raised. However, in our conversations with management, the company noted that whilst it would certainly love to spend cash at a greater rate, as this would mean that more projects will be moving forward in the pipeline, the higher cash balance has not changed at all the company's approach to R&D and the company is in no rush to spend the money it has (unless it has viable programs wherein to do so). Whilst we do think there could be a big step up in R&D costs if the Toledo program advances into phase 2, the company noted that these phase 2 programs may not need to be particularly large in terms of number of patients relative to some of the filgotinib trials. In any event, we don't have anything for Toledo in our model and will need to see how the company guides for operational cash burn in 2020; we haven't learned anything thus far to cause us to change our approach in modelling this.

Rinvoq launch – you can spin it both ways but it's probably a positive for the class thus far

One other topic that comes up a lot in GLPG discussions is the launch of Abbvie's (not covered) Rinvoq in RA in the US (see: GLPG/UCB/VIFN: Halloween hangover - more laterals to our names (GLPG, UCB and VIFN) (01/11/19)). The impact of this is tougher to parse out to GLPG; a strong Rinvoq launch can be spun as a positive (it's good for the JAK class and the "next gen" JAKs; i.e. a rising tide lifts all boats) or as a negative (reinforces the first-mover-advantage of the strongest commercial player in immunology, thus making it a more difficult climb for GILD, with filgotinib being the first product it will be launching in the space).

We've gotten a lot of feedback from US investors that their survey work has indicated that rheumatologists are quite skeptical of the next gen JAKs and are particularly concerned regarding safety (see: GLPG/NOVN/SAN: JAK survey - key EU takes (09/05/19)). We do have some early indicators though that, now that Rinvoq is actually on the market, prescription patterns are suggestive of a pretty strong launch which we think is bullish for both Rinvoq and filgotinib on the whole, rather than assuring the dominance of one over the other.

Doctor's Guide Publishing Ltd. recently conducted a snap poll of 37 US-based rheumatologists to gauge early sentiment towards Rinvoq (published on 10/12/19). 59% of respondents have

prescribed Rinvoq this far since the August launch, with an additional 19% indicating that they expect to prescribe the drug in the near future. The vast majority of prescribing docs are impressed with the drug thus far (64% are “moderately impressed” and 27% are “very impressed”). Whilst 8 in 10 respondents do indicate that safety is a concern when considering whether or not to prescribe the drug, 76% believe that the boxed earning labelling for all the JAK inhibitors (including Xeljanz and Olumiant) is comparable (indicating that if filgotinib gets a class boxed warning (as is the base case expectation), this should not be a limiting factor for the drug’s launch).

Importantly for filgotinib, 2/3 of rheumatologist said it is “too early” to assess whether Rinvoq is a best-in-class JAK inhibitor, leaving room for Gilead to promote for filgotinib’s (in our view) superior safety data.

…last but not least, the always popular “short covering”

One thing we’ve written extensively about all year is our sense that there’s a big difference in sentiment across the Atlantic in terms of how investors view GLPG. In the US, particularly amongst specialists, we’ve sensed a more bearish consensus towards GLPG (particularly on the peak sales potential of filgotinib and on the viability of the IPF program) than in Europe. Given that there’s a perceived lack of catalysts until either the SELECTION phase 2 data for filgotinib in ulcerative colitis and/or the filgotinib approval/label (whichever comes first, but both likely around mid-year 2020), we’ve heard feedback that GLPG is a popular name to short (particularly with the takeout risk off the table). Thus, this adds to the confusion of GLPG’s recent outperformance and one of the most common refrains we’ve heard lately is that this could be a result of short covering.

However, the short interest for GLPG has actually increased pretty sharply as a % of the float as of late, indicating to us that it’s more the aforementioned “real” buying driving GLPG shares higher vs. short covering.

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