ILMN

**Analyst Note** 05/04/2016



[Illumina Should End 2016 on Better Note After Rough First Quarter](http://quicktake.morningstar.com/StockNet/san.aspx?id=752472)   
by Michael Waterhouse, 05/04/2016

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Following management's follow-up discussion of factors affecting Illumina’s previously disappointing earnings preannouncement, we stand by our initial thoughts that the slower revenue growth in 2016 reflects a tough comparison with 2015 results, combined with weakness in Europe and some sluggishness among the firm's higher throughput instrument placements. We currently interpret the depressed results as predominantly stemming from timing of instrument shipments and some delayed orders among budget-conscious customers, rather than from the potential effects of competitive pressure, market share shifts, or a shrinking in the market opportunity. While this supports our view that Illumina's narrow economic moat remains stable, we think these issues, particularly weakness in Europe, will potentially persist over much of 2016 and perhaps even longer. We're therefore somewhat skeptical that management’s initiatives, including restructuring sales leadership in Europe and simplifying contract complexity for large orders, can dramatically improve the company’s performance. Additionally management plans to re-evaluate the pace of spending and investments to help ease the bottom-line pressure. We might make a few minor adjustments to our model, as our current adjusted EPS estimate of $3.45 is at the top end of management’s outlook, but we don’t foresee any material change to our fair value estimate.

We think easier comparisons in the back half of the year, combined with new product sales and moving through the existing backlog, can enable Illumina to reach near 12% growth for the year. Illumina's Americas segment growth of 14% helped offset revenue declines in Europe and Asia, leading to relatively weak 6% growth for the quarter. Tough comparisons with early 2015 and weaker-than-anticipated deliveries of the HiSeq product line led to a 20% decline in instrument revenue. Meanwhile, consumables revenue climbed 17%, thanks largely to a 24% increase in sequencing consumables.

### Morningstar's Take

## ILMN

* [Analyst](javascript:chgTab('analyst');)

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| --- | --- | --- | --- |
| Price 05-12-2016 | | Fair Value Estimate | Uncertainty |
| 136.94 USD | | 130 USD | High |
|  | | | |
| Consider Buy | | Consider Sell | Economic Moat |
| 78 USD | | 201.5 USD | Narrow |
|  | | | |
| Stewardship Rating | | | |
| Exemplary | | | |
|  | | | |
|  |  | | | |
| Bulls Say | | | | |
|  | | | | |
| • | Genome sequencing remains a relatively nascent market, representing a large growth opportunity for Illumina's instruments. | | | |
|  | | | | |
| • | Weak economic conditions have constrained global research budgets, but academic, government, and commercial markets have specifically prioritized sequencing research. | | | |
|  | | | | |
| • | Illumina currently has the largest, and growing, installed base of sequencing instruments, which translates into ongoing sales of higher-margin consumables. | | | |
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| Bears Say | |
|  | |
| • | An emerging sequencing technology could eventually leapfrog Illumina’s platform, leading to market share losses. |
|  | |
| • | A significant portion of Illumina’s market growth will require clinical adoption of sequencing technology, which faces considerable regulation, validation, treatment guidelines, and reimbursement challenges. |
|  | |
| • | Illumina’s future success depends on management’s ability to sustain innovation and astute capital allocation. One misstep could prove costly. |
|  | |

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| --- | --- | --- | --- | --- |
| **Name** | **Price** | **% Chg** |  | **TTM Sales  $ mil** |
|  | | | | |
| Illumina Inc | $136.94 | -1.38 |  | 2,253 |
| [Becton Dickinson & Co](http://quotes.morningstar.com/stock/BDX/s?t=0P000000QR&culture=en-US) | $167.15 | 0.06 |  | 12,234 |
| [Baxter International Inc](http://quotes.morningstar.com/stock/BAX/s?t=0P000000QB&culture=en-US) | $45.63 | -1.64 |  | 9,940 |
| [Essilor International SA ADR](http://quotes.morningstar.com/stock/ESLOY/s?t=0P0000BQ10&culture=en-US) | $64.25 | -0.57 |  | 7,678 |
| [Essilor International SA](http://quotes.morningstar.com/stock/ESLOF/s?t=0P0000BVUP&culture=en-US) | $127.50 | -1.92 |  | 7,678 |
| [Coloplast A/S ADR](http://quotes.morningstar.com/stock/CLPBY/s?t=0P0000TO7V&culture=en-US) | $7.59 | -1.63 |  | 2,192 |

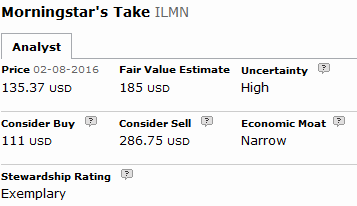
Illumina is a major player in life science tools for analyzing genetic material. Revenue from microarray and genome sequencing machines and disposables make up most of the company’s revenue, but approximately 10% of the company’s sales come from sequencing services. Essentially all of Illumina’s growth stems from the company’s genome sequencing products, which include the company’s high-throughput HiSeq instruments in addition to its benchtop NextSeq, MiSeq, and MiniSeq product lines. Sequencing is roughly two thirds of the product business.

Illumina's fourth-quarter results held few surprises following management's preliminary numbers and 2016 guidance released earlier this year, so we're keeping our fair value estimate in place for now. Although global currency and macroeconomic issues remain a concern regarding Illumina's near-term performance and some investors may not appreciate the near-term earnings slowdown from new sequencing service ventures (Helix and Grail), we think the company's long-term growth opportunity remains attractive, particularly as clinical adoption of the technology still looks very small.

Rumors of Roche's acquisition talks with Pacific Biosciences do not shift our view on Illumina's narrow economic moat. Roche remains an aggressive consolidator in the genome sequencing market, which will probably enhance the firm's understanding of complex sequencing enzymes and chemistry, but we still see limited applications for Pacific Biosciences' technology despite recent platform enhancements. Nonetheless, disruptive risks will always remain a long-term issue for Illumina, should someone leapfrog its leadership in innovation, and we still view Roche and Oxford Nanopore as the most pertinent contenders.

**Investment Thesis** 01/20/2016

As the current hands-down leader in genomic sequencing, Illumina faces an impressive growth opportunity as the emergence of this technology creates new research applications while also potentially disrupting many existing clinical diagnostic markets. Accelerating demand for Illumina's products combined with operating leverage potential should sustain high earnings growth.   
  
Technological advancements in the sequencing industry have brought down the cost of assembling one genome from nearly $3 billion and 13 years by completion of the Human Genome Project in 2003, to almost $1,000 in a matter of days following the announcement of Illumina’s HighSeq X in early 2014. Further innovation should continue to push down these costs, enhancing accessibility to this technology. With the number of sequenced human genomes likely in the low hundreds of thousands, we also see plenty of opportunity for increased demand, especially in oncology and reproductive health. We estimate the genome sequencing market opportunity exceeds $20 billion.  
  
Growth in demand for genome sequencing places Illumina as the clear winner for the time being. Illumina’s on-instrument solid-phase amplification and fluorescently labeled sequencing-by-synthesis technology support one of the most versatile platforms in the industry. By nearly every measure--sample preparation time, run costs, turnaround time, read lengths, throughput, and error rates--Illumina squashes the current competition. It also offers a strong assortment of sample preparation and post-run data analysis tools, including its open-source and cloud-based data storage and genome assembly software.   
  
In the near term, we think Illumina can continue its leadership, but threats from disruptive technologies will remain a concern. Ongoing improvements in the company’s flow cell density, chemistry processes, and camera speeds should support throughput and cost improvements. While some emerging technologies have made big promises, we’re unconvinced for now that these emerging systems can dethrone Illumina. In the meantime, Illumina pursues its own innovative methods, including nanopore and chip-based detection devices.



Narrow moat:

We’ve awarded Illumina a narrow moat. We’re cognizant that Illumina is a young company in an emerging market with potential for disruptive technologies, but we believe relatively high barriers to entry, rising switching costs, and Illumina’s unmatched pace of innovation should support economic profits over the next decade. Even though the risk of emerging technologies on the horizon is the largest concern for Illumina’s moat, in our opinion, we currently view the threat of a major disruptive technology as remote.

Illumina currently dominates the genome sequencing market, where instrument versatility, low operating costs, high throughput and accuracy, turnaround speed, faster and simpler sample preparation, and supportive data analysis software make up the driving force behind the company’s market share. Illumina's market share is nearly 75% and growing, based on our estimates. However, owing to the company’s essential monopoly of the high-throughput portion of the market, over 90% of sequenced genetic material likely comes off an Illumina machine.

Our model incorporates average revenue and non-GAAP EPS growth of 16% and 20% over the next five years, respectively. We think Illumina commands a high multiple thanks to long-term growth opportunities in the genome-sequencing market along with the limited competitive threat of emerging technologies. We assume Illumina can sustain its high revenue growth thanks to three primary factors. First, improving macroeconomic conditions should ease customer research budgets in addition to greater shifts in funding resources toward sequencing technologies. As the leading sequencing technology in the market, Illumina should benefit from this increased spending on sequencing. Second, we think Illumina will continue to gain market share from Roche and Thermo Fisher, enabling the company to grow faster than the cumulative sequencing market. Third, Illumina’s ongoing product advancements should continue to improve sequencing throughput and costs helping to extend the company’s customer base, especially in the clinical diagnostics market. Illumina's gene panel and prenatal testing opportunities hold considerable growth potential as well.